House prices in Sweden

Despite the fact that the Swedish economy is in a deep recession, house prices are rising. There are signs that house prices are currently slightly above the level that can be considered sustainable in the long term. However, several factors indicate that house prices will increase more slowly in the future. At the same time, overly optimistic expectations of future interest rates or more expansionary credit granting could entail risks in the long term. It is therefore important that all those who affect the housing market take some responsibility for ensuring that its development is sustainable in the long term.

House prices in Sweden have risen by just over 3 per cent between the second and third quarters of this year, although the economy is in a recession and unemployment is expected to increase over the coming years. The Riksbank's assessment is that the repo rate will be kept low for a long period of time to come, and this is justified by the forecasts for inflation and resource utilisation. The reason for this is to support the economic recovery. The low interest rate stimulates general demand, as well as consumption and investment in housing. As price formation is to a great extent governed in the short term by demand in this sector, it creates a certain amount of pressure on prices. If the rising house prices are signalling an increase in consumer confidence, then there is no major problem. But if prices are developing beyond levels that are sustainable in the long term, then there is an increased risk of a problematic correction in the future, entailing negative consequences for both financial stability and the real economy.

Supply and demand affect house prices

One to two years ahead the supply of housing is to a large extent known, as it takes a long time to build new houses, which means that the price is most affected by demand in the short term. This in turn is governed by households' current and expected incomes, by expectations of future house prices and by costs – in particular interest rates. Other important factors are the access to credit and the banks' lending policy. Lower amortisation requirements lead to greater opportunities for taking on large loans, which may push up prices. How strict the banks are in their credit assessment is probably also a significant factor as a less-rigorous credit assessment means that households can increase their loans.

The effects of monetary on the demand for housing can be divided into a direct and an indirect channel. The direct channel affects households' mortgage costs and thus the demand for housing. The indirect channel has an effect on the demand for housing in that inflation, GDP, employment and so on are affected by changes in interest rates.

Long-term price developments are determined by production costs and land prices. Productivity in housing construction is weaker than the average productivity in the economy as a whole. This means that production costs for housing will increase more quickly than the average rate of price increase in the economy as a whole. A more severe shortage of suitable undeveloped land, combined with rising real incomes will also contribute to higher prices for land to be developed. Both of these factors mean that house prices may in the long term increase more quickly than consumer prices on average.

What factors lie behind the development of housing prices in Sweden in recent years?

Prices of single-family dwellings have increased rapidly since the mid-1990s (see Figure A3). It is difficult to say exactly what rate of increase is sustainable in the long term. However, the Riksbank's assessment is that the average price increase of around 8 per cent a year since 1996 is not sustainable in the long term.

The main reason for the large increase in prices is that the demand for housing has been very high. This is partly due to large increases in income but also to households having increased their borrowing at a rapid pace. Since 1996 the average rate of increase in household borrowing has been over 9 per cent a year (see Figure A3). The high level of indebtedness means that households are tying up an unusually large share of their future incomes in housing. House prices and households' debts in relation to disposable incomes have almost doubled since 1996. It is probable that this is mainly due to the change in the credit markets during this period. The banks became less restrictive in their mortgage lending and reduced their demands for cash down-payments, as well as granting higher first mortgages, which enabled households that had previously had limited access to credit to obtain loans. Moreover, the development towards lower inflation meant, all else being equal, that the rate of amortisation on the loans should have increased to obtain the same real instalment profile as before. But the rate of amortisation declined instead. All in all, this has enabled an expansion in total credit granting that tended to increase the demand for housing.

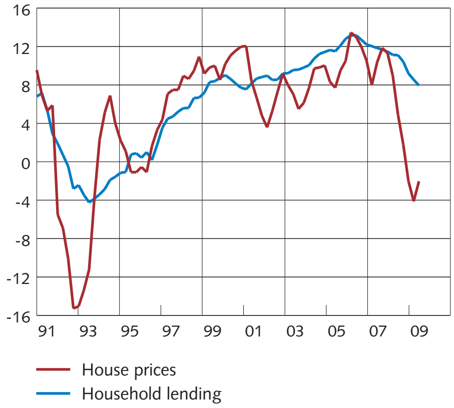
One mechanism that may have reinforced the demand for housing is the possibility that Swedish households engendered unrealistic expectations of future increases in housing prices, as happened in the USA according to Robert Shiller.[22] Given the dramatic and uninterrupted rise in housing prices in the period 1996–2007, it is not unreasonable to believe that this also occurred in Sweden.

Finally, the supply of housing, measured as housing construction, has been very low both in historical terms and in an international comparison since the early 1990s (see Figure A4).

Monetary policy may also have contributed to the unusually high demand for housing, as interest rates have been low during the period in question. However, the relatively expansionary monetary policy is in turn due to macroeconomic developments, which affect house prices via several different channels.

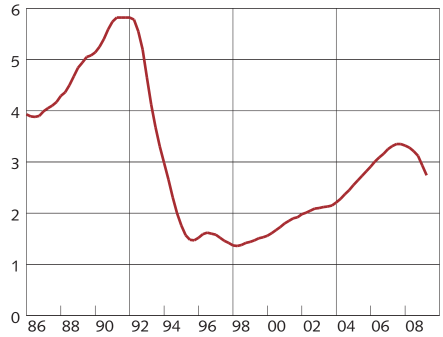
22 R. Shiller, "Understanding Recent Trends in House Prices and Home Ownership", Federal Reserve Bank of Kansas City, Jackson Hole Symposium 2007.

Figure B3. Single-family dwelling prices and household lending
Annual percentage change



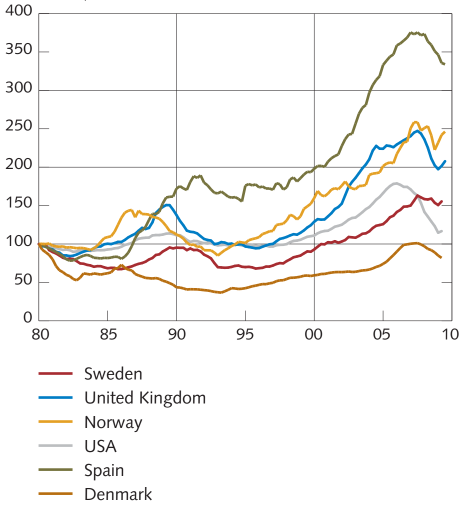
Sources: Statistics Sweden and the Riksbank

Figure B4. Housing investment
Percentage of GDP, current prices



Note. Four-quarter moving average.
Source: Statistics Sweden

Figure B5. Real house prices in Sweden and abroad
Index, 1980=100



Note. Single-family dwelling prices deflated using consumer price index.

Source: Reuters EcoWin

Developments in house prices in Sweden compared with other countries

In Sweden house prices increased much more quickly than consumer prices on average from the middle of the 1990s. Real house prices more than doubled between 1996 and 2007. This development is not unique to Sweden. In several other countries real house prices doubled over a ten-year period, and in some cases, such as Ireland and Spain, they rose even more (see Figure A5). The fall in house prices that took place in connection with the economic crisis has been relatively small in Sweden, compared with many other countries, such as the United States, the United Kingdom and Spain (see Figure A5).

All in all, from 1996 and just over 10 years ahead, real house prices increased almost as much in Sweden as in some other countries where house prices have fallen much more in connection with the crisis. This could possibly be an indication that house prices in Sweden will develop weakly in the future.[23] However, there are arguments as to why the decline in house prices has not been as great in Sweden as in other countries. Firstly, new construction in Sweden has been at a much lower level than in other countries since the beginning of the 1990s. Moreover, Swedish households buy their housing to live in, not to rent out. In the United Kingdom and in Ireland, where house prices have fallen substantially, there has been a large market for buy-to-let. This means that a house or apartment can be bought for the sole purpose of letting it, which has added a speculative element to the housing market that largely does not exist in Sweden.

One possible explanation as to why developments in house prices have been so similar in large parts of the world could be the increasingly globalised financial markets. New products, for instance, mortgage-backed bonds, enabled an increased credit expansion.

How will house prices develop in the future?

The Riksbank has used a model for the housing market to analyse developments in house prices.[24] The estimated long-term trend in the model indicates that nominal house prices will increase by around 5 per cent a year in the long term. However, estimates from a single model or a specific time period are always very uncertain. Other models may give rise to other estimates. Data from the 1950s onwards indicate that real house prices in principle did not rise at all up to the middle of the 1950s. Data for the United States over an even longer period of time also show that real house prices had a much lower rate of increase up to the middle of the 1950s than during the following period.

23 The IMF World Economic Outlook, October 2009, puts forward arguments for a weak development in house prices in the future in Sweden and several other countries is put forward

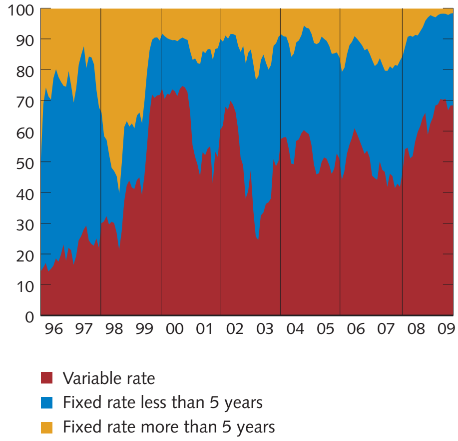
24 This is a general equilibrium model that apart from describing the housing market also captures the link between the housing market and other parts of the economy. The model is described in more detail by P. Sellin and K. Walentin in "House prices and the economy", Economic Commentary no. 6, 2008, Sveriges Riksbank. A more detailed technical description of this type of model can be found in M. Iacoviello and S. Neri, "Housing Market Spillovers: Evidence from an Estimated DSGE Model", American Economic Journal: Macroeconomics, under publication.

Despite the uncertainty of the estimate, there are nevertheless many indications overall that house prices are above their long-term trend at present, and that this will have a dampening effect on future developments in house prices.

Three factors might bring prices back to a trend in the longer term. Firstly, if households go back to putting a smaller share of their income into housing, in line with historical behavioural patterns, then demand should decline. Secondly, the weak development in the labour market will contribute to a low demand for housing. Thirdly, and in the longer term, increased housing construction will contribute to an increase in supply and slow down house prices. In contrast to these dampening factors we have the current low interest rate which, seen in isolation, contributes to higher housing prices.

All in all, there are arguments in favour of house prices increasing at roughly the same rate as consumer prices (measured in terms of the CPIF) over the coming years, and in this case real house prices will remain unchanged.

Figure B6. Households' new loans broken down into diffeerent maturities
Per cent



Source: The Riksbank

What risks exist in a long-term perspective?

The low interest rate at present is motivated by the general economic situation, and the forecast for the repo rate is expected to contribute to a recovery in the Swedish economy and to a CPIF inflation rate of around 2 per cent during the forecast horizon. It is important that the interest rate remains low for a relatively long period to come. However, it is also important to remember that the repo rate will rise in the future, and a reasonable normal level for the repo rate is much higher than the current level. If developments in the housing market reflect these expectations, the increase in house prices should be moderate in the future.

Rapidly-rising house prices over a long period of time could indicate unreasonable expectations of low interest rates in the future. The percentage of households taking on mortgages at a variable rate has also risen relatively sharply in the recent period (see Figure A6). Rising interest rates could then lead to an abrupt fall in house prices further ahead, which could have negative consequences for the real economy.

However, monetary policy is only one of many tools that could be used in a scenario where credit expansion and house prices were considered to be increasing at a rate that is not tenable. Monetary policy has no specific target for house prices, but looks at the development of the economy as a whole. Moreover, the interest rate is too blunt an instrument to use for fine-tuning house prices. Of course, this does not rule out the possibility of some consideration being given to developments in the housing market to the extent the Riksbank considers this necessary, given the macroeconomic risks.

Normally, a rapid credit expansion and rising house prices coincide with a general economic upswing. Then it is possible to raise the interest rate without any conflict of interests. However, situations may arise where credit volumes and house prices develop in an untenable manner, at the same time as the general economy requires the support of a low interest rate. If the Riksbank is then to maintain a low interest rate and stimulate the economy, it is important that authorities with supervisory responsibility and also the banks themselves ensure that lending is sustainable in the long term by having sufficient margins in their credit calculations. Fiscal policy can also contribute to a more stable development in the housing market through changes in, for instance, property tax, stamp duties and opportunities for tax relief for interest expenditure.

Summary and conclusions

What then are the overall conclusions of this analysis? There are some signs that house prices in Sweden are currently above the long-term trend. If this conclusion is correct, then continued high rates of increase in house prices could entail future risks for both financial stability and the real economy. It is important that all those who affect the housing market take some responsibility for ensuring that its development is sustainable in the long term. It is also important that those who take on loans at variable interest rates now realise that the interest rate will rise to a much higher level in a few years' time – even if it is initially low to stimulate the economy during its recovery phase.