ANALYSIS

Finnish household debt accumulation follows economic cycle

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Over recent decades, Finnish households have constantly accumulated debt in relation to their income. The household savings rate has also been mainly negative. However, during recessions households typically save more and accumulate less debt than in economic upswings. Despite the low savings rate and continuous growth in debt, the value of the household sector's financial wealth has increased faster than the value of its debts. This is attributable to a considerable appreciation in the value of financial assets. As a consequence, the household sector's financial position has strengthened in spite of the accumulation of debt, resulting in an overall improvement in households' financial room for manoeuvre. However, asset prices can decrease substantially in a downturn, which would weaken the financial position of households and limit their borrowing capacity.

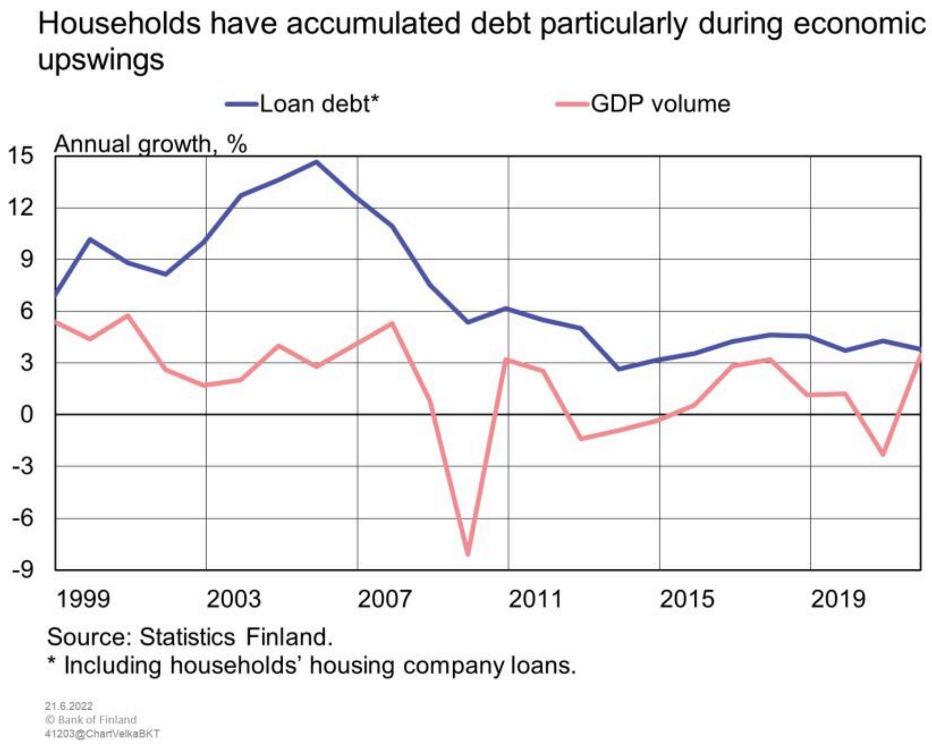
Household debt accumulation has persisted a long time

The ratio of household debt relative to disposable income, i.e. the household debt-to-income (DTI) ratio, has more than doubled since 2000, rising from 63% to 136% (Chart 1). Households' loan debt also includes their actual share of the loans their housing company has taken out. Housing company loans have markedly pushed up the household DTI ratio over the past ten years. Taking only personal loan debts into account, the DTI ratio was 120% at the end of 2021.

Chart 1.

The pattern of household debt accumulation follows the economic cycle. Loan debt has, on average, grown rapidly during economic upswings and more moderately during recessions (Chart 2). This could be explained by many factors. Growth in household indebtedness is, at least to some extent, limited by the level of income growth. Households can borrow more when economic conditions are favourable and incomes increase at a rapid pace. In addition, changes in asset prices in line with economic cycles can limit households' borrowing capacity, as collateral values typically rise in upswings and fall in recessions.

Chart 2.



The general observation globally and in Finland is that banks often relax their lending standards in good times and tighten them in bad times. In upswings, banks may grant longer loans, accept riskier collateral and provide loans even to applicants with relatively weak creditworthiness. In recessions, in turn, banks are more cautious. Households can also be more cautious in downturns and recessions, and may not be as tempted to take on debt as in good times.

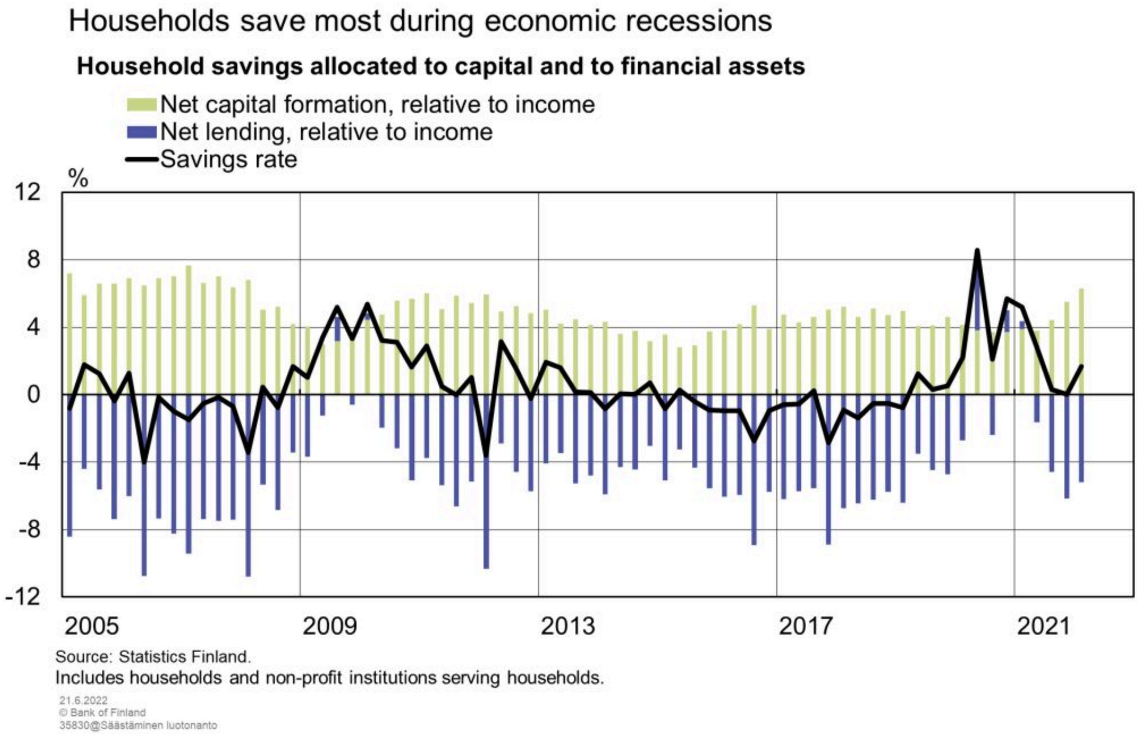
In upswings, debt growth is typically curbed by tightening monetary policy and rising interest rates. In recessions, in turn, monetary policy is more relaxed and interest rates lower, supporting households' borrowing capacity and ability to fund purchases and investment. In short, monetary policy smooths the cyclical fluctuations in indebtedness. Euro area monetary policy has been very accommodative since the financial crisis, and interest rates have long been very low. Loan servicing costs have therefore been historically modest relative to household income, which has contributed to making borrowing attractive. At the same time, it appears that the very low level of interest rates has not fuelled household indebtedness overall to any great extent. Debt has continued to grow at a fairly stable rate in recent years compared with the period before the financial crisis (Chart 2). On the other hand, if interest rates had been higher, this would likely have further slowed the growth of debt.[1]

Households borrow less and save more in recessions

Households can invest their savings either in tangible assets (e.g. housing, natural resources and valuables) or in financial assets (such as deposits, fund shares or equity shares). Household saving can also be negative, meaning consumption expenditure by households exceeds their disposable income. In such cases, the difference must be financed either by credit or by realising assets. Net lending refers to the accumulation of financial assets after deduction of the financial liabilities accumulated.

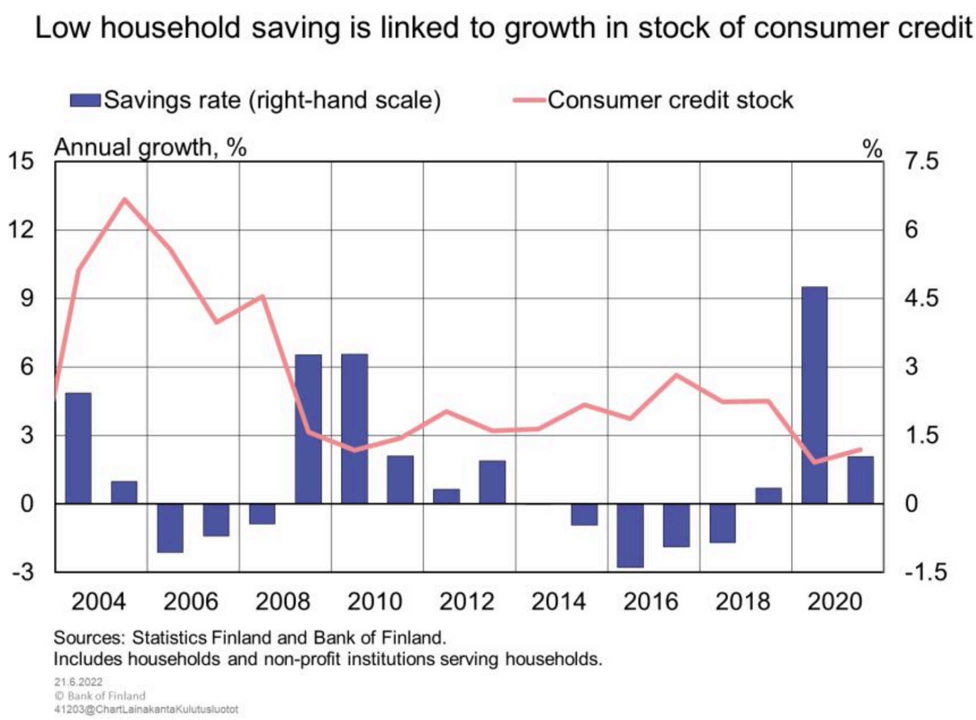
Since the turn of the millennium, households have invested an average of 5% of their disposable income (taking into account consumption of capital) in accumulating tangible assets – mostly housing (Chart 3).[2] At the same time, households have constantly accumulated more debt than financial assets. Consequently, the household sector has been a net borrower in recent decades. Only in recessions – during the financial crisis and the COVID-19 crisis – have households accumulated more financial assets than debt. The household savings rate has also been positive during these recessions.

Chart 3.



The Bank of Finland's statistics on monetary financial institutions provide data on the purposes for which banks operating in Finland grant loans to households. These statistics show that the stock of consumer credit granted to households has grown particularly rapidly when the savings rate has been negative (Chart 4). This suggests that households have partly financed their consumption expenditure with debt. Growth in the stock of other debt items (housing loans and other loans) is not similarly linked to movements in the savings rate.

Chart 4.

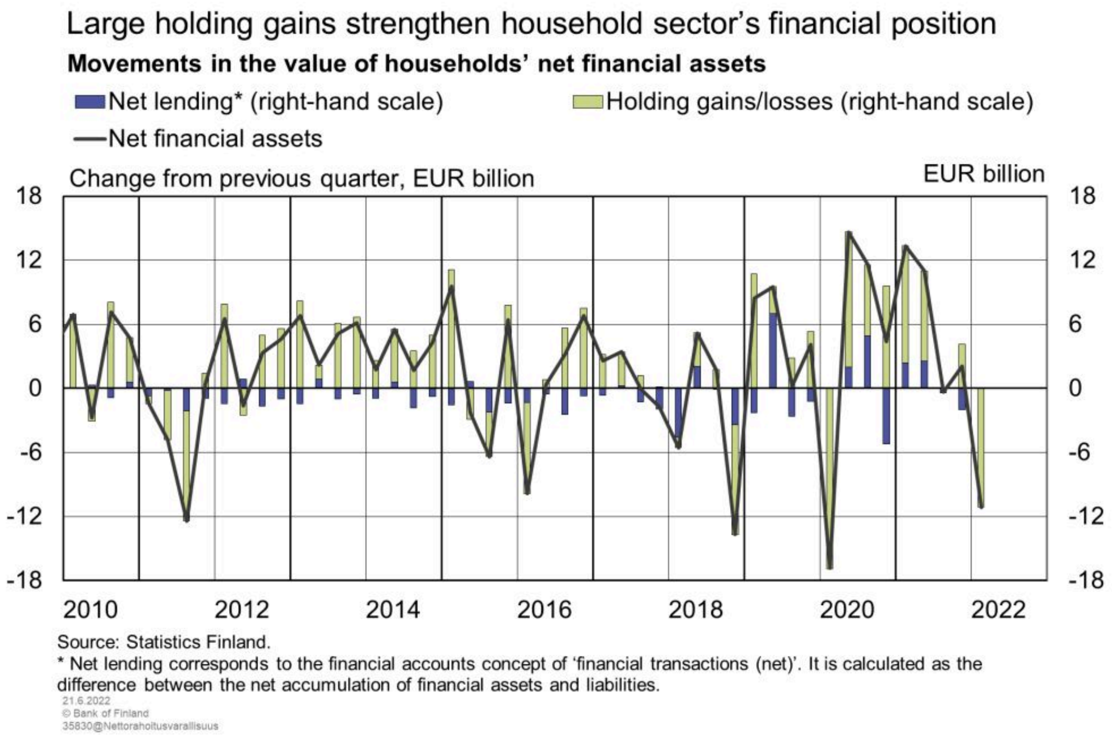


Besides debt, households also hold considerable amounts of financial wealth. The net financial assets of households, i.e. the difference between financial assets and financial liabilities, have increased continuously. At the end of 2021, households' financial assets totalled almost EUR 420 billion, as compared with liabilities of EUR 205 billion. Hence, the value of financial assets was over double the value of liabilities.

The strengthening of the financial position irrespective of continuous net borrowing reflects the appreciation of asset items, i.e. holding gains (Chart 5). Holding gains have been significantly higher on average than net borrowing, which has made it possible for households to continuously accumulate debt.

Holding gains are, however, sensitive to cyclical fluctuations. The financial position may deteriorate rapidly in downturns, which is likely to weaken households' borrowing capacity. By contrast, a solid financial position provides a financial buffer for the aggregate household sector, although there can be marked differences in the positions of individual households.

Chart 5.



Growth in loan stock tracks income and interest rate dynamics

According to the Bank of Finland's forecast produced using a new loan stock model, the stock of loans granted by monetary financial institutions to households will continue to expand in the immediate years ahead, albeit at a relatively moderate pace.[3] The moderation is explained by the fact that income growth will slow and market interest rates will rise by 2024 (Chart 6).

Chart 6.

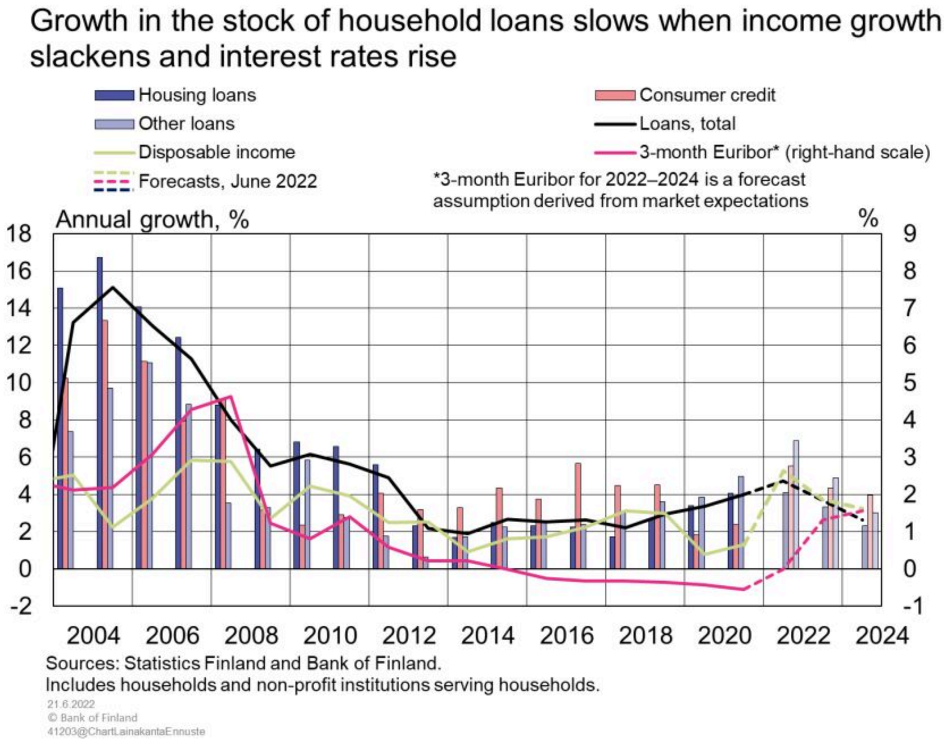

Growth in the stock of household loans slows when income growth slackens and interest rates rise
Housing loans
Other loans
Disposable income
Forecasts, June 2022
Consumer credit
Loans, total
3-month Euribor* (right-hand scale)
*3-month Euribor for 2022–2024 is a forecast assumption derived from market expectations
Annual growth, %
%
18
16
14
12
10
8
6
4
2
0
-2
9
8
7
6
5
4
3
2
1
0
-1
2004
2006
2008
2010
2012
2014
2016
2018
2020
2022
2024
Sources: Statistics Finland and Bank of Finland.
Includes households and non-profit institutions serving households.
21.6.2022
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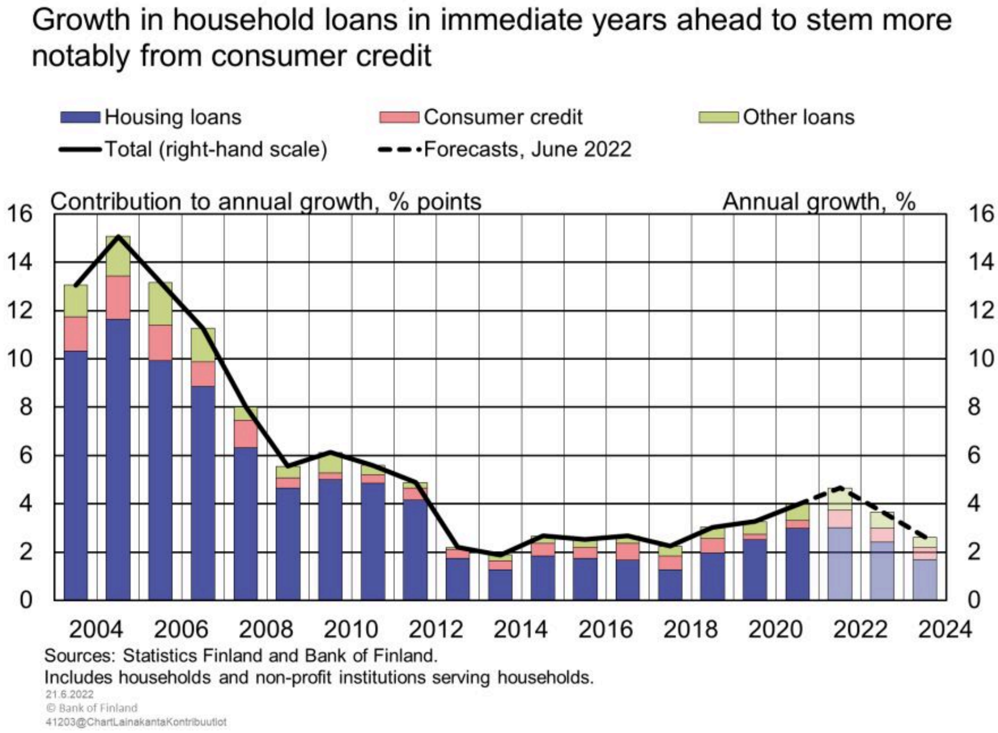
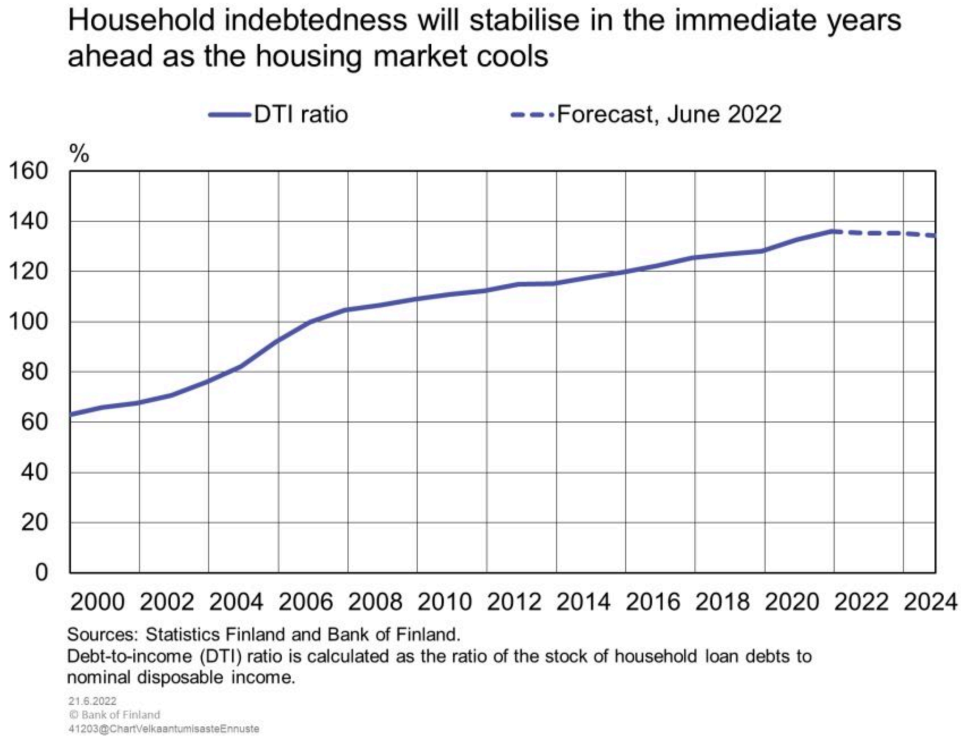
Chart 7.



The COVID-19 pandemic has reshaped the composition of household debt. Prior to the pandemic, the stock of consumer credit expanded at a brisk annual pace, and consumer credit made a significant contribution to the growth in the aggregate stock of household loans. At the same time, the housing loan stock grew fairly modestly (Chart 7). The growth rate in the stock of consumer credit began to edge down in 2020, when the economy drifted into a recession and private consumption contracted. Last year, the growth in the stock of consumer credit came to a complete halt and the growth rate in the housing loan stock strengthened, as the pandemic resulted in households strongly shifting consumption from other consumption to housing.

During the forecast period, the stock of consumer credit is expected to resume relatively brisk growth, on the back of an increase in consumption expenditure due to high inflation.[4] Overall, household debt will grow roughly in step with income, as growth in the housing loan stock will abate in the next few years in response to the cooling of the housing market. Thus, the household DTI ratio is projected to stabilise (Chart 8).

Chart 8.



Conclusion

Finnish households have accumulated debt in recent decades, irrespective of the cyclical situation. At the same time, the financial position of households has improved due to an appreciation in their financial wealth.

Growth in the stock of household loans has typically picked up and the household savings rate has declined during upswings, while the opposite has been the case in downswings. This suggests that households are more cautious during downswings, borrowing less and saving more. Households can also be subject to various credit constraints that bind their borrowing capacity to income growth, asset price fluctuations and overall cyclical conditions.

In the immediate years ahead, the stock of household loans is expected to grow at about the same rate as disposable household income. Consumer credit growth will outpace growth in housing loans, as high inflation fuels household consumption expenditure and the housing market cools. However, a more moderate level of income growth and a rising level of interest rates will curb the growth in loans.

Notes

1. Loan-specific data collected jointly by the Bank of Finland and the Financial Supervisory Authority shows that the median size of new housing loans relative to the income level of the borrower has grown significantly in recent years. This means that the debt-servicing capacity of housing loan borrowers is also more sensitive to changes in interest rates and income. See New housing loans keep growing in size – increased share of longer-than-usual loans. ↑
2. In the National Accounts, capital formation also comprises acquisitions of existing dwellings in housing companies and real estate. At the level of the aggregate household sector, however, sales of existing dwellings do not increase the capital stock (except for the amount of brokerage expenses and transfer tax, which are accounted for in the value of the capital stock). Renovation of existing dwellings and real estate, in turn, increases the stock of capital. ↑
3. The household loan stock forecast is based on data available on 24 May 2022. For a description of the loan stock model, see A model for predicting Finnish household loan stocks. ↑
4. Growth in essential consumption expenditure may lead to a particularly sharp reduction in indebted households' room for manoeuvre financially. See Weakening economy and tightening financing conditions pose a challenge to financial stability. ↑

Key words

economic cycles, household indebtedness, saving