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Economics Group

Special Commentary

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Could Rising Rates Derail the Swedish Economy?

Executive Summary

The Swedish economy capped 2017 on a solid note, with economic growth registering 2.7 percent for the year and inflation returning to the central bank's 2 percent target. Improving economic conditions in Sweden have brought about an inflection point for monetary policy, and a rising rate environment appears imminent. With a heavy household debt burden and the potential for higher interest rates on the horizon, how is Sweden's economy positioned to handle these headwinds?

Improving economic conditions in Sweden have brought about an inflection point for monetary policy.

Our analysis suggests that gradual increases in the repo rate, the Swedish central bank's main policy rate, will slow economic growth only modestly in the years ahead. A sharper-than-expected upward move in the policy rate would create a more outsized drag on economic growth, but we believe there are factors in place that would help prevent a doomsday downward spiral. The Swedish central government is in excellent fiscal health at present, and if debt service ratios were to rise dramatically, policymakers could reduce taxes to boost the cash flow of households and firms. In addition, high household saving rates give Swedish households flexibility to reduce their saving and smooth out their consumption over time.

Swedish GDP Growth Solid in Q4

Swedish GDP grew 0.9 percent (not-annualized) in Q4, bringing the year-over-year pace of growth to 3.3 percent (Figure 1). Strong export growth and steady household consumption drove economic growth in the quarter. Government consumption was a bit soft, and gross fixed capital formation saw some payback, declining 1.3 percent in Q4 after growing 3.8 percent (not annualized) in Q3. Over the past year, economic growth has become increasingly broad-based. Year-ago growth strengthened in each quarter of 2017, climbing from 1.9 percent in Q1 to the 3.3 percent registered in this morning's print. Household consumption, gross fixed capital formation and exports have all accelerated in the past 12 months or so, boosted by a more favorable global economic backdrop.

Strong export growth and steady household consumption drove economic growth in the quarter.

Figure 1

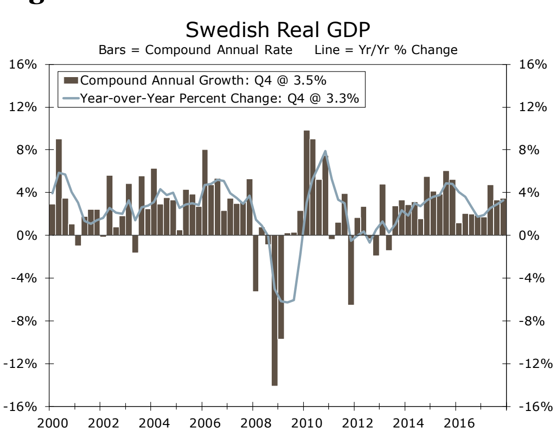
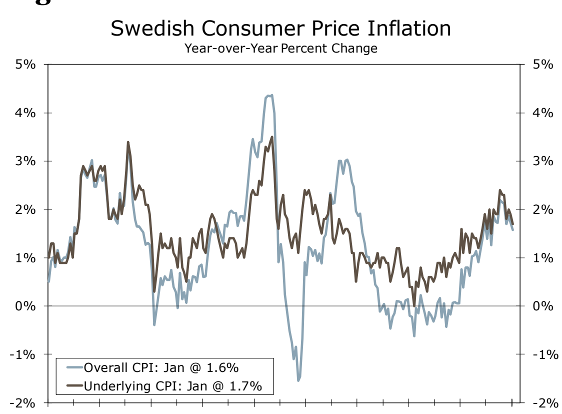


Figure 2



Source: IHS Markit and Wells Fargo Securities

Consumer price inflation picked up speed and briefly shot above 2 percent toward the end of last year before receding slightly.

The unemployment rate declined alongside the faster economic growth, albeit at a relatively slow pace, falling 0.4 percentage points to 6.5 percent between December 2016 and January 2018. Inflation in Sweden has moved more decisively; after hovering near deflation territory for most of the 2013-2016 period, consumer price inflation picked up speed and briefly shot above 2 percent toward the end of last year before receding slightly (Figure 2). House prices declined in the later months of 2017, and a stronger Swedish krona toward the end of the year may have held down import prices. At its last policy meeting, the Swedish Riksbank noted that inflation expectations have recovered from their previous low levels and are "close to 2 percent," the central bank's inflation target. This trifecta of stronger economic growth, falling unemployment and close-to-target inflation has positioned the Riksbank to start the process of transitioning from an expansionary phase of the monetary policy cycle to a tightening phase.

Rising Rates and Levered Households: Should We Worry?

In a recent special report, we looked at rising household leverage in advanced economies to ascertain whether global economic growth could be threatened by tighter monetary policy and higher interest rates.[1] One economy that appears particularly at risk is Sweden. Improving economic conditions in Sweden have brought about an inflection point for monetary policy, and a rising rate environment appears imminent. Sweden's central bank ceased adding to its bond portfolio at the end of 2017, and the most recent monetary policy minutes suggest gradual rate increases will commence in the second half of 2018. Thus, it seems likely that the Swedish Riksbank will join the swelling ranks of central banks moving to tighten monetary policy in 2018.

The household debt-to-income ratio in Sweden has risen more or less unabated since the turn of the century.

The household debt-to-income ratio in Sweden has risen more or less unabated since the turn of the century, well out-pacing the highs seen in the United States during the peak of the housing bubble (Figure 3). Sweden is one of just a handful of developed economies that saw its household debt service ratio increase since Q4-2007 as falling interest rates and deleveraging brought down financing costs in most countries across the developed world (Figure 4). With a heavy debt burden and the potential for higher interest rates on the horizon, how is Sweden's economy positioned to handle these headwinds?

Figure 3

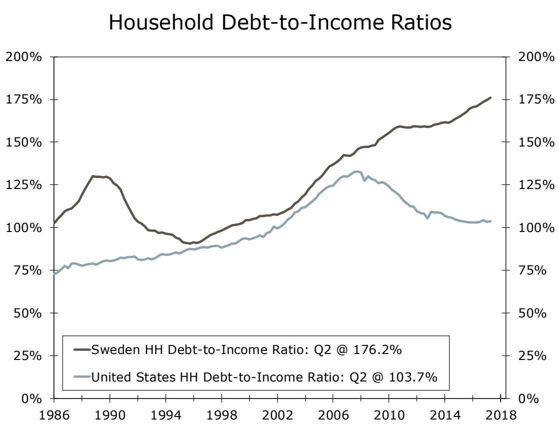
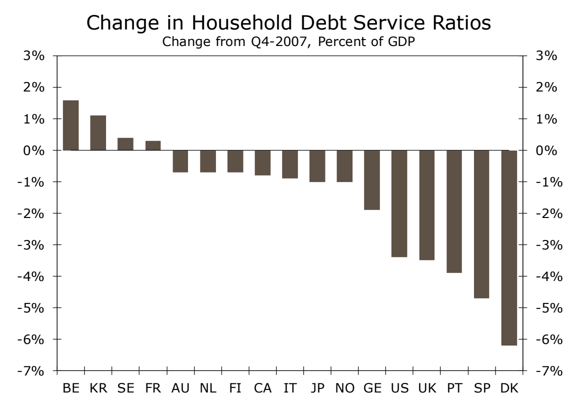


Figure 4



Source: Bank of International Settlements, IHS Markit and Wells Fargo Securities

At first glance, the situation seems ominous. Sweden's household debt service ratio is 11.4 percent, roughly where it was at the onset of the Great Recession despite 525 bps of policy rate easing and a large asset purchase program undertaken by the central bank over the past decade (Figure 5). A climbing debt service ratio in the face of negative interest rates demonstrates just how much the stock of debt has risen in aggregate for Swedish households. Swedish non-financial corporations appear to be in better shape, as the debt service ratio for these companies has been halved over the past few years amid the Riksbank's foray into negative rates (Figure 6).

[1] **For further reading on this topic, see "Rising Household Leverage: Should We Be Worried?" (February 20, 2018). Wells Fargo Economics. Available upon request.**

Figure 5

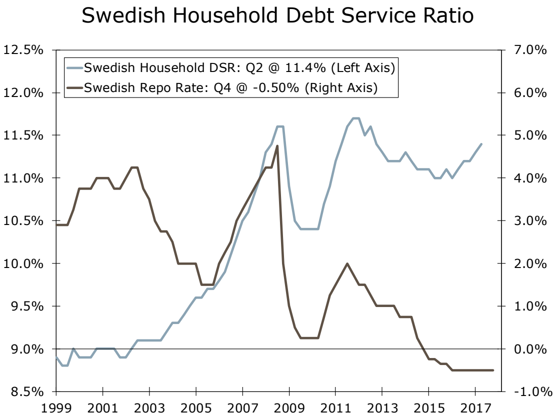
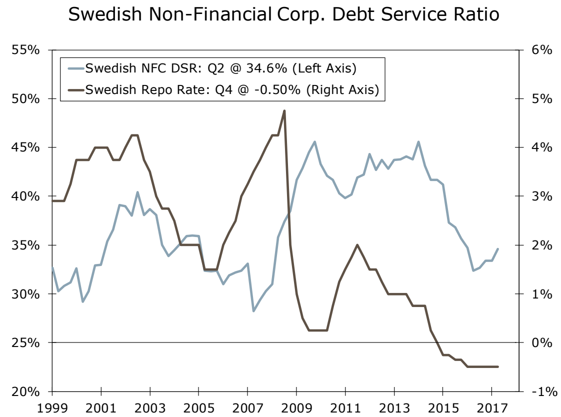


Figure 6



Source: Bank of International Settlements, IHS Markit and Wells Fargo Securities

Higher interest rates would raise debt service ratios and divert a larger share of household income toward debt financing, all else equal. This in turn would likely reduce personal consumption, dampening economic growth in the short-run. A recent report released by the Riksbank analyzed the direct effect on households from an increase in the repo rate over the next three years in line with the central bank's forecast.[2] The projected 125 bps increase in the repo rate between now and 2020 would reduce disposable household income by just over 1 percent. This finding is consistent with our own analysis in our recent leverage report and suggests slower economic growth at the margin, but an effect that falls far short of an economic doomsday scenario. We do not explicitly forecast real GDP growth in Sweden, but the International Monetary Fund looks for real GDP growth to slow from 3.1 percent in 2017 to 2.4 percent this year and 2.1 percent in 2019. This slowdown seems reasonable to us given the anticipated effect from rising rates.

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Reasons to Sleep Easier: Fiscal Policy & Household Saving

Although the projected monetary policy tightening may slow economic growth modestly over the next few years, what if interest rates were to increase faster or the effect on households was larger than expected? We believe there are two key factors that could help Swedish households and firms cope with higher rates: fiscal policy flexibility and high household saving rates.

On the fiscal policy front, the Swedish central government is in an enviable place, with a debt-to-GDP ratio of just 27 percent and an unexpectedly large budget surplus in the most recent fiscal year (Figure 7). In the wake of Sweden's economic woes in the 1990s, the government adopted a budget surplus target of 1 percent of GDP over a business cycle. This policy helped bring down the debt-to-GDP ratio to healthy levels and afford Sweden the capacity to ease fiscal policy significantly, should the need arise. The fiscal success of the last decade-and-a-half recently led policymakers to set a new, slightly lower level for the surplus target of one-third-of-one percent of GDP, effective in 2019.[3] If debt service ratios rise faster than expected and begin to create macroeconomic disruptions, policymakers could use the fiscal wiggle room to cut taxes and boost after-tax income for Swedish households and firms. With such a low debt-to-GDP ratio, and the Swedish Riksbank holding roughly 40 percent of outstanding Swedish government bonds, policymakers could choose to adopt an even less austere fiscal policy stance if conditions warranted it, at least for a while.

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[2] Sveriges Riksbank. (2017). "How Are Households Affected by Rising Interest Rates?" Article in Monetary Policy Report, December 2017. A link can be found here.
[3] An announcement of the change can be found here. The committee in charge of studying and reviewing these fiscal policy changes released a more detailed report on its findings, which can be found here.

Figure 7

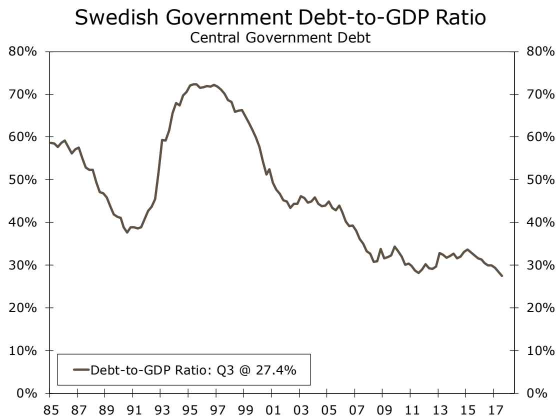
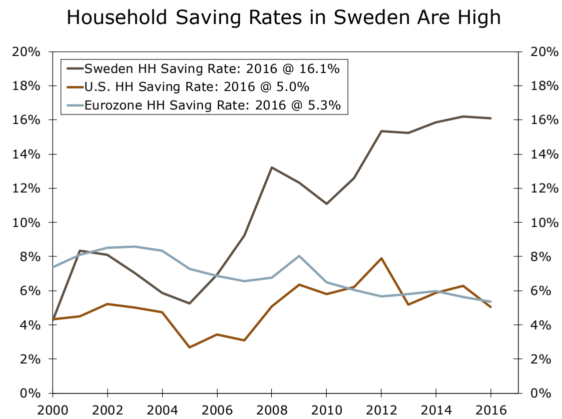


Figure 8



Source: IHS Markit, OECD and Wells Fargo Securities

Swedish households could reduce their saving to smooth out their consumption through a rising rate environment.

Another avenue through which higher interest rates could be mitigated is a reduction in saving. Swedish households save a disproportionate share of their incomes relative to the United States or the Eurozone (Figure 8). A recent study from the International Monetary Fund suggested multiple driving factors behind this phenomenon, including a structural shift lower in consumer confidence, the abolition of the wealth tax in 2007, the large savings needed to buy a home in Sweden's hot housing market and the unusual demographic profile of a simultaneous increase in the elderly and youth-age dependency ratios (the result of an aging native population and rising refugee population).[4] Regardless of the cause, Swedish households could reduce their saving to smooth out their consumption through a rising rate environment. The unusually high saving rate in Sweden may in fact be partially explained by households anticipating higher interest rates and debt service costs. If this is indeed the case, the effect on growth from rising rates would be even smaller than expected should actual events follow household expectations.

Conclusion

Economic growth in Sweden rebounded in 2017 and finished Q4 with year-over-year growth north of 3 percent. Both domestic and foreign demand have been the catalysts for faster growth. In addition to the stronger GDP growth, unemployment continues to gradually decline and inflation has moved comfortably into the Riksbank's inflation target variation band of 1-3 percent. As a result, monetary policy in Sweden has likely reached an inflection point. Sweden's central bank ceased adding to its bond portfolio at the end of 2017, and the most recent monetary policy minutes suggest gradual rate increases will commence in the second half of 2018.

If the repo rate increases in-line with the Riksbank's forecast, the effect on economic growth should be relatively modest.

The prospect of tighter monetary policy, however, has raised concerns over the private debt burden in Sweden, particularly for highly indebted households. Higher interest rates could increase debt service ratios, diverting household income toward interest payments and stunting consumption growth. In our own opinion, if the repo rate increases in-line with the Riksbank's forecast, the effect on economic growth from higher interest rates should be relatively modest. If interest rates rise more rapidly than expected, the drag on growth could be larger than expected. However, high household saving rates and low levels of government debt could act as mitigating factors if needed, which should help prevent the Swedish economy from becoming completely derailed by rising rates.

4 International Monetary Fund. (2017). Sweden: Selected Issues. IMF Country Report No. 17/351. https://www.imf.org/en/Publications/CR/Issues/2017/11/17/Sweden-Selected-Issues-45415

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