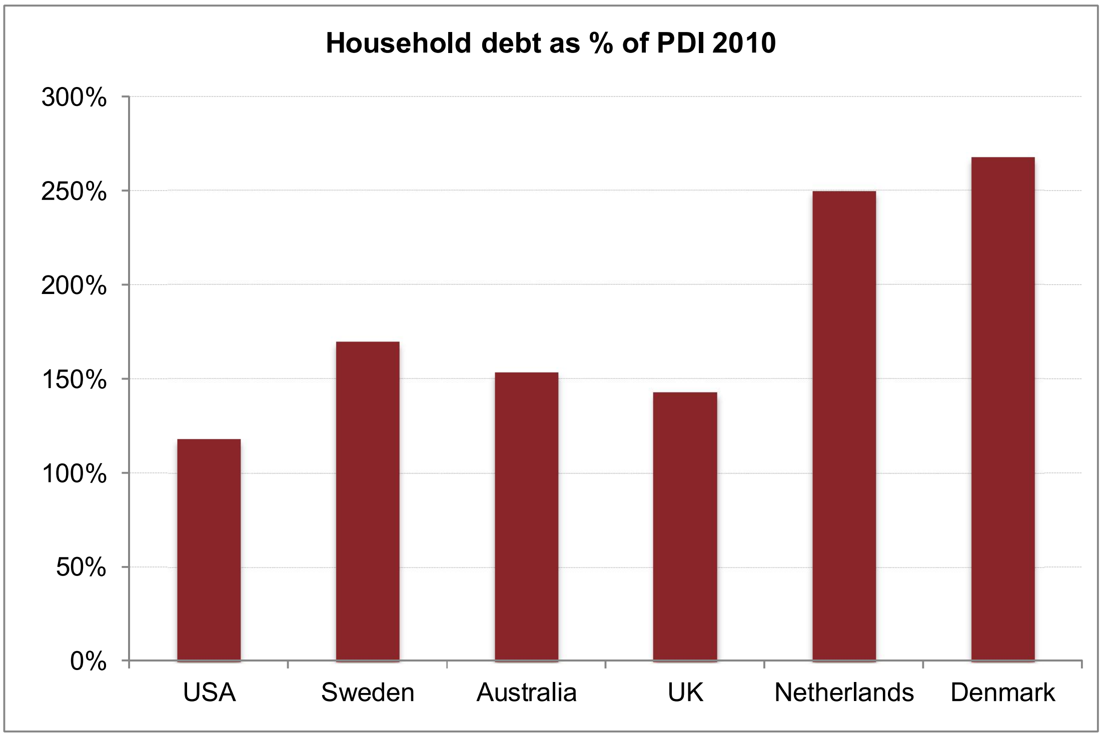
High household savings are a cushion, not a cure-all

Swedish household behaviour puts economy at risk

There is rarely only one cause behind economic developments. But, whatever the manifold reasons behind the Global Financial Crisis (a k a the Great Recession), it is clear that one of the triggers was when American households could no longer service their debt. This happened when their debt burden reached just short of 130% of personal disposable income (PDI) in 2008. Since then, US households have deleveraged, and now have a debt/PDI ratio of just below 110%, a figure which previous research I have done implies is within the maximum stable zone (100-110% of PDI).

However, if this explains why US households had to stop spending and start saving, it does not explain why households in other countries were – and are – able to live with far higher debt/PDI ratios. In Australia the ratio reached close to 155% of PDI and is now barely below 150%; in Sweden the number has been close to 180%, although it too is now below 150%; and in Denmark the debt/PDI ratio peaked at over 250% in 2010.[1] What explains the difference?



[1] Please note that the data comes from different sources and is therefore strictly speaking not 100% comparable. But the magnitudes are right and they are what matters here.

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First, we can take it as read that the bulk of household debt is housing debt. That implies that the bulk of the debt is mirrored on the asset side of balance sheets by the value of the house. This would go some way towards explaining why household debt is higher in small countries with limited living space, such as the UK, Australia or the Netherlands, than in the US. But it does not explain why Swedish households happily carry a higher debt than American, given Sweden's (relatively) large size and small population.

Nor, to continue on housing, does it seem to matter if mortgage interest is deductible – as in the US and Sweden – or not, as in the UK. Variable interest rates help, of course, particularly if they are rapidly falling. But the bulk of mortgage lending is at variable rates not only in the US (where even if it is technically not variable, it is relatively easy to change the loan) and in Sweden and Denmark.

However, one key factor that can perhaps explain some of the difference in the capacity to cope with debt is the household savings rate. Although the numbers have been revised in different directions as part of the regular US national accounts revisions, US household savings are by international standards very low, averaging 3.6% over the past ten years compared with 6.9% in Denmark, 10% in Sweden and more than 12% in the Netherlands. Only in the UK and Australia was the ten-year average nearer that of the US at 4.7% and 4.6% respectively.

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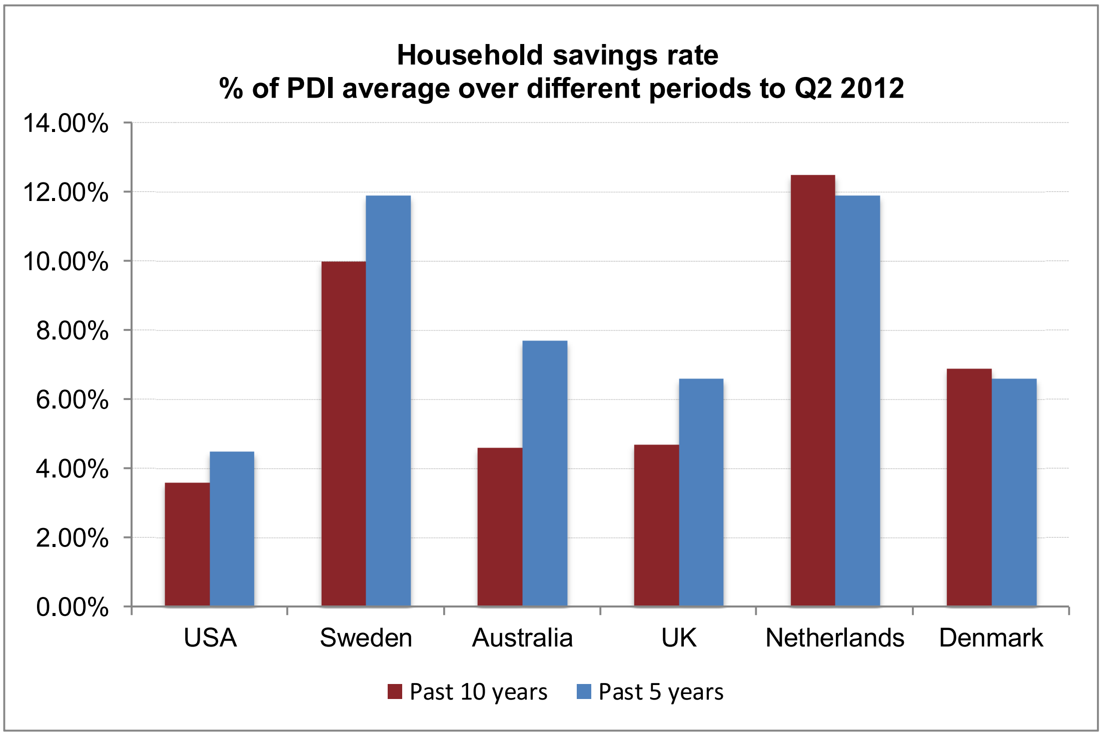

The reason a higher savings ratio would help off-set the effects of higher debt, is because if the interest rate burden rises, households can draw down their savings rate (or even their savings) and continue to consume at the same rate as before; whereas if they save little or nothing, they have to lower their consumption in order to service their loans.

In theory, this could be measured by seeing if households drew down their savings rate when the crisis struck (or drew down their consumption). This does seem to be what happened in the Netherlands and in Denmark. By contrast, in Sweden and – even more so – in Australia and the UK, the savings rate rose. This is because households accelerated their deleveraging process, since debt repayment counts as savings. However, a breakdown of the savings data by quarters does show that, even in Sweden and Australia, the initial household response to the crisis was to draw down the savings rate somewhat, supporting this argument.

This is not the whole story, of course. Spanish households also saved in the double-digits, an average of 12.2% in the past ten years and of 13.5% in the past five years, but the crisis struck an over indebted Spanish household sector badly. So clearly there are other factors involved as well.

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A crucial one seems to be the interaction between savings and amortisation. The Reserve Bank of Australia has noted that part of the reason for the (relative) weakness of the Australian economy in recent years has been that households are pre-amortising, ie paying down debt. By contrast, in Sweden, although there is an on-going debate about forcing households to amortise debt on a regular basis, much lending is still done on the basis of interest-only payments. This is clearly a risk for the future: at some stage, interest rates will rise. At that stage, Sweden, which in recent years has been a star performer among developed nations, could face a rapid slowdown. (This will to some extent be off-set by stronger exports, as higher interest rates are only likely to come when the world economy has recovered, which will benefit a small open economy like the Swedish). By contrast, Australia should from this perspective do better (of course, Australia's main weakness is not household debt but its commodity dependence).

Ultimately, therefore, what can be said is that a high savings rate can enable households to carry a higher debt burden. Focusing solely on household debt is therefore only half the story. But, it also seems clear that when that debt burden becomes overwhelming, the higher debt ratio is likely to make the recovery more protracted. This is not least because deleveraging means an even higher savings rate,π ie, lower rate of consumption.

I began researching this comment feeling that higher savings explained why countries could sustain higher household debt. I finish writing it with a much greater sense of worry about the future of the Swedish – and Danish and Dutch among others – economies.

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