Box 1 An international comparison of household debt

Iceland has a high level of household debt, but not the highest internationally

As discussed elsewhere, debt stock is an imperfect measure of the burden that it places, or will conceivably place, on future household income. However, a ratio which is high in a historical or international context could indicate risk. In the following, a quarter of a century of debt accumulation by Icelandic households will not be discussed further. Instead the focus is on their position compared with other countries. Such a comparison is no less problematic. Iceland's position in the community of nations does not ultimately answer the question whether its high household debt poses a risk. Other nations have also been through phases of debt accumulation in recent years. Thus their economies may have also become more exposed than before.

Size of the public sector, housing ownership, pension funds and age of population explain the debt ratio to some extent

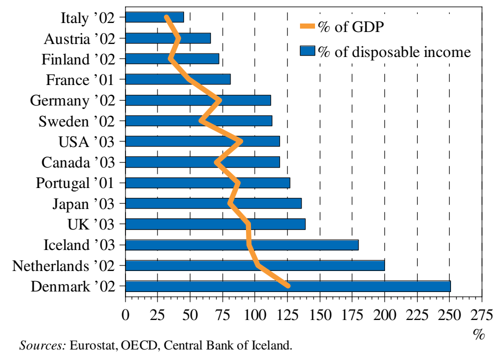
By international comparison, Iceland has one of the highest ratios of household debt whether in terms of disposable income or GDP. Chart 1 shows the ratio of household debt in selected countries. Iceland is rated third in this group on both counts, but the lower-ranking countries follow closer behind it in terms of GDP. A number of possible explanations can be given for Iceland's high ratio of household debt to disposable income. In countries with a large public sector, disposable income is lower by the equivalent of its higher direct taxes. It is normal for Iceland to have a higher ratio of household debt to disposable income than, for example, Japan or the US. The ratio of household debt to GDP, on the other hand, is unaffected by the tax level.

Another explanation for Iceland's high household debt is the large proportion of private housing. More than 80% of housing is owner-occupied in Iceland, compared with just under 70% in the UK, 55% in France and a little more than 40% in Germany, which has the lowest level among Western countries. Families in rented accommodation pay rent instead of interest and instalments on mortgages. Their financial obligations are not necessarily less and may not be much easier to divest, e.g. by moving to a smaller property, than those of owner-occupants.

If a high level of owner-occupancy does to some extent explain the high debt ratio, this implies that households probably own considerable assets to offset their debts. If these assets are liquid and have a higher value than their debts, temporary financial distress on the part of borrowers will be less likely to cause setbacks in the financial system. A rough estimate of household equity as a ratio of disposable income and GDP in selected countries is shown in Chart 2, and the asset-debt ratio in Chart 3. By these criteria Iceland ranks lower than various large nations where data are readily available, although not so very far behind some of them.

Chart 1

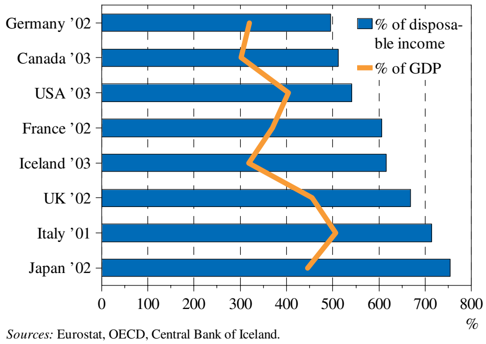
Household debt in selected countries



Sources: Eurostat, OECD, Central Bank of Iceland.

Chart 2

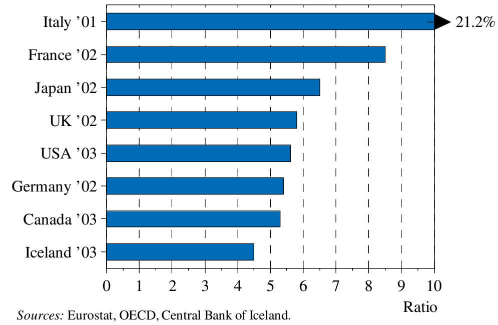
Household equity in selected countries



Sources: Eurostat, OECD, Central Bank of Iceland.

Chart 3

Household debt-to-asset ratio in selected countries



Sources: Eurostat, OECD, Central Bank of Iceland.

Certain items behind the statistics for Iceland's household debt, and in particular for assets, are only rough estimates. Bearing this qualification in mind, the ratio of household equity to GDP is not out of line with that of the G-7 economies. Iceland's pension funds make a substantial difference, since assets held with them and with insurance companies are included with household equity in these statistics. It should be kept in mind that assets held in a pension fund normally cannot be used to pay off household arrears. However, they are a guarantee for future income flow and reduce the need for equity in the form of low-mortgage housing on retirement. Individuals with good pension rights can therefore allow themselves a higher level of indebtedness as they approach retirement age than would otherwise be the case. This may explain why Dutch, Danish and Icelandic households rank with the most heavily indebted – all these countries have strong pension fund systems.

The third explanation for Iceland's household debt figures is its younger average age of population than the other countries in the comparison. This almost certainly brings down the ratio of equity to GDP and raises the debt level.

Finally, under the definition of disposable income used in Iceland in recent years, capital earnings are included, while interest expenses are deducted. Thus higher household debt drives up the ratio with double effect, because the numerator increases at the same time as the denominator decreases.[1]

1. It would seem to be more logical to use the income that households have at their disposal for meeting debt service, as the denominator.