Westpac Institutional Bank

Household debt levels now higher than before the financial crisis

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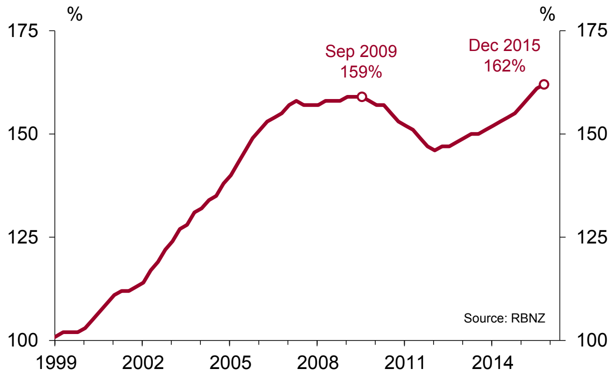
- Household debt is rising fast. Relative to incomes, household debt levels are now higher than the peaks reached prior to the financial crisis.
- Households' increased appetite for debt has been boosted by the current extended period of very low interest rates in New Zealand. These low borrowing rates have bolstered household spending and the housing market, and are providing some offset to the weakness in other parts of the economy.
- However, the resulting run up in debt signals important challenges for the economy over the coming years. Most notably, the eventual repayment of debt will be a drag on growth. In addition, any future increases in interest rates could challenge the strength of house prices that debt has been secured against, and the ability of households to service debt.
- The above considerations mean the Reserve Bank faces a delicate balancing act between its monetary policy goals (which favour continued low interest rates) and its macroprudential aims of limiting the risks for the financial system. These two sets of policies are interconnected, but at times can conflict with each other. And this is one of those times.

Figure 1: Household debt as a share of disposable incomes (including investment housing)



Why have household debt levels been increasing?

Continued low interest rates have sparked a sharp increase in household borrowing at a time when income growth has been very modest. Since 2012, households' annual disposable incomes have risen by around 10%, while debt levels have increased by 22%.

This combination of conditions has seen the amount of debt households are carrying rising to levels equivalent to 162% of their annual disposable incomes.[1] That's higher than the peaks reached prior to the financial crisis and has completely reversed the reduction in debt levels seen in preceding years (figure 1).

1 Even if debt on investment property is excluded, household debt levels relative to disposable incomes have climbed above pre-crisis peaks.

In part, this increase in borrowing reflects that the RBNZ has set interest rates at very low levels in response to very low inflation and a barrage of significant economic headwinds, both domestically and offshore.

Low interest rates have boosted debt in two ways. The first is by making it less expensive for households to fund consumption spending using debt.

The second has been through low interest rates leading to higher asset prices. In particular, strong growth in house prices has boosted household wealth and encouraged household spending.[2] Much of this is a result of passive housing equity withdrawal: With low interest rates generating low nominal returns on savings, the higher rental yields and capital gains that housing assets have generated have been very attractive for investors. The resulting increases in demand for housing, especially non-owner occupied investment housing, has boosted house prices. In turn, this has generated a windfall for existing home owners, some of which has been spent. These conditions have resulted in house buyers borrowing more, while existing owners spend more. The net effect on the economy is more borrowing and more spending, with the low cost of borrowing reinforcing these trends.[3]

The resulting debt-funded increases in household spending and strengthening in the housing market are helping to offset some of the weakness in other parts of the economy, particularly the dairying sector.

Furthermore, with the OCR likely to drop further during the current cycle and to remain low for some time, continued increases in debt levels are likely.

Debt looks serviceable for now...

Some pick-up in debt levels in response to low interest rates isn't necessarily a problem. In fact, with low interest rates encouraging borrowing, this indicates that one of the key channels that monetary policy uses to influence the economy is operating as expected.

In addition, although households' debt burdens have been increasing, low interest rates mean that the proportion of households' incomes spent on debt servicing has actually remained low (figure 2). And it's likely that debt servicing costs will drop further over the next few months as recent interest rate reductions pass through to the rates faced by households.

Furthermore, a notable feature of the increase in debt levels in recent years is that much of it has been secured against housing assets, including investment housing (figure 3). Looking at households' debt levels compared to their assets, there has been a stark improvement in recent years. In fact, debt-to-asset ratios are currently at their lowest levels since 2007 (figure 4).

Figure 2: Debt servicing costs as a share of households' disposable incomes

Figure 3: Household assets

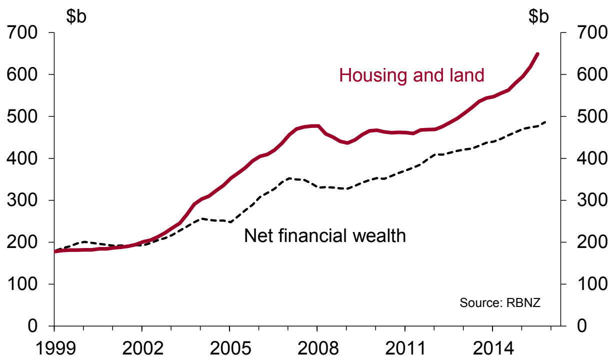
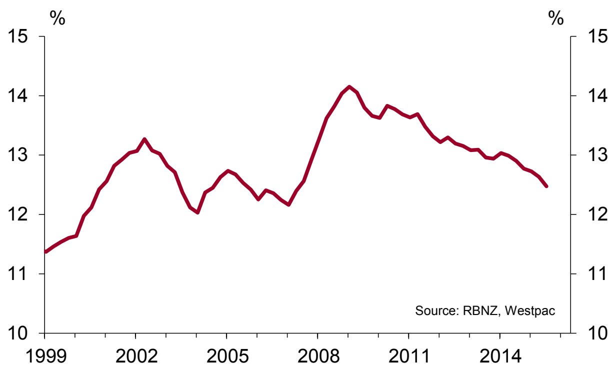


Figure 4: Households' debt-to-asset ratios



...but higher debt signals increased risk for the economy over the coming years

The recent run up in debt still raises some important concerns for the economy over the coming years, signalling challenges for longer term growth and increased vulnerability to unfavourable changes in economic conditions.

2 While the RBNZ doesn't deliberately try to boost house prices, this is an almost inevitable consequence of the current interest rate environment.

3 Higher house prices have also boosted spending by allowing households to borrow against the increased equity in their homes, and through increased levels of consumer confidence associated with higher levels of wealth resulting from increases in house prices.

First of all, increases in debt can't generate increases in growth indefinitely. Households will eventually need to repay debt, and larger increases in debt now will require larger reductions in spending in future years. This will be a drag on growth over the coming years. In addition, when interest rates do eventually increase, debt servicing costs will rise. And given the strong increases in household debt, the resulting pull back in household spending could be stark.

An additional concern is the role that low interest rates have played in boosting both households' debt levels and their wealth. As noted above, households' debt-to-asset positions have improved in recent years. But much of this apparent improvement is because low interest rates have boosted house prices, flattering households' financial positions. At the same time, low interest rates have encouraged borrowers to take on additional debt. Over the life of a housing loan borrowing rates could rise. And in the past there have been substantial increases. If this occurs, it could have a dramatic impact on both asset prices and debt servicing costs, creating significant downside risks for economic activity:

- If interest rates increase, many borrowers will find their debt servicing requirements ratcheting up, and for highly indebted borrowers such increases could be marked. In some cases, debt could even become unserviceable.
- Simultaneously, higher interest rates would make housing assets look a lot less attractive. This would put downward pressure on prices, and could see debt-to-asset positions deteriorating, just as they did during the financial crisis. In such circumstances, many borrowers would find their borrowing ability curtailed, while debt servicing requirements result in their disposable incomes being squeezed – a combination of conditions that would drag spending levels down.
- Adding to such concerns is that many highly indebted borrowers have used funds to purchase investment properties. High house prices have left rental yields at a low level. And if interest rates increase, these yields may not be sufficient to meet debt servicing requirements.[4]

More generally, even in the absence of interest rate increases, higher debt levels mean the economy is more vulnerable to unfavourable developments in economic or financial conditions. This is because households have less of a buffer from changes in economic conditions. With this in mind, it's important to remember that GDP growth is set to slow in latter part of the decade. If this also results in a softening in the labour market, more highly indebted households could find themselves struggling to repay debts.

What does all this mean for the RBNZ?

For the RBNZ, the combination of low inflation and increasing household indebtedness in the economy will require a delicate balancing act between its monetary policy and macroprudential aims. These two sets of policies are interconnected, but at times their goals can conflict with each other. And this is one of those times.

In terms of monetary policy, the RBNZ is bound to keep the OCR at low levels due to the weakness in inflation. However, this will inevitably lead to higher asset prices and debt levels, which adds to the risk for financial stability over the coming years. Consequently, we're unlikely to see any easing in macroprudential settings anytime soon. In fact, there is a risk that we could see some tightening in macroprudential settings over the coming years, which would make the task of raising inflation back to 2% on a sustained basis more challenging.

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4 Reserve Bank Financial Stability Report, November 2015.

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