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News release

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Household Indebtedness, the Exchange Rate and Risks to the UK Economy – Speech by Sushil Wadhwani

In a speech to the Macclesfield Chamber of Commerce, Sushil Wadhwani, a Member of the Monetary Policy Committee, discussed the risks to the UK economy emanating from growing indebtedness and an 'overvalued' exchange rate.

Summary

Risks from growing household indebtedness

While the current rate of growth in household debt is clearly unsustainable, the vulnerability of the economy to rising debt can be overstated. Debt servicing ratios are below average, and the debt-assets ratio has actually fallen over the last decade. The inflation-adjusted savings ratio is above its long-term historical average, and the rise in the debt-income ratio might be a by-product of the move to a low inflation environment. While the rise in debt poses some clear risks, it is important that we do not exaggerate them.

The exchange rate and future instability - some lessons from down under

There is a concern that growing household debt must ultimately undermine the exchange rate, which will then be associated with a sharp rise in inflation and interest rates, thereby precipitating a crash in house prices and consumption.

There are, though, other possibilities. Both Australia and New Zealand have experienced significant exchange rate depreciations at a time when household indebtedness was rising strongly. So far, the impact on consumer price inflation has been less than would have been suggested by past historical relationships, with inflation expectations, non-tradeables inflation and unit labour cost growth remaining benign. Changes in interest rates have been relatively modest, and, over the period, house prices have grown. Unemployment has continued to fall in New Zealand, and Australia registered 4% real GDP growth in 2001 despite the global slowdown. The exchange rate depreciations have aided an improvement in their underlying current

account positions. So far, their experience suggests that we may similarly avoid a 'bust', though, of course, we shall need to remain vigilant.

High debt, an overvalued exchange rate and appropriate monetary policy

Another argument is that the risks posed by debt and the exchange rate should lead the MPC to hold interest rates higher than is necessary to hit the 2 year-ahead inflation target. I find this argument to be unconvincing, because such a policy might lead to an even higher exchange rate, which might exacerbate current imbalances and potentially increase future inflation volatility. Moreover, a high interest rate policy might sufficiently weaken the corporate sector such that some future adverse development could increase unemployment more than would otherwise have been the case.

Key Resources

Household Indebtedness, the Exchange Rate and Risks to the UK Economy - Full Speech
http://www.bankofengland.co.uk/archive/Documents/historicpubs/speeches/2002/speech166.pdf