BANK OF ENGLAND

Speech

Puzzles in Today's Economy – The Build Up of Household Debt

Speech given by

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PUZZLES IN TODAY'S ECONOMY – THE BUILD UP OF HOUSEHOLD DEBT

Leverage & Debt: Benefit & Vulnerability

A key economic debate of the day is whether we, as a society, should be concerned about the level of debt borne by families, businesses and, indeed, governments. We are all aware of the positive role of debt in the development of market economies and social well-being. But equally we are aware that increasing leverage can give rise to vulnerabilities – think of LTCM in 1998 - and increase the possibility that external shocks or changes in perceptions will lead to unexpected results that impact on the stability of the financial system and the setting of monetary policy.

On the whole the increasing availability of debt is beneficial. Debt helpfully allows households, companies and even countries to smooth their spending patterns. But as with many things in life, there are potential downsides. It is often said that central bankers and regulators tend to look on the pessimistic side and to see "the glass as half empty". As a former regulator, and now a central banker, I am perhaps likely to be doubly cautious and to focus on the potential vulnerabilities!

Improved access to debt may indeed be beneficial overall, although high levels of debt can cause difficulties for companies and for countries. Evidence also suggests that the burden of debt does pose a genuine problem for a minority of households. And, as I will discuss in more detail below, an increase in indebtedness may increase the sensitivity of households - and the economy in general - to future shocks, although by how much is very uncertain.

For public policymakers, the evaluation of these vulnerabilities and the appropriate policy response is a matter of continued debate. What levels of debt are sustainable? And what could be the impact of a break-down or crisis of one sort or another?

At the Bank of England we take an interest in this subject at several levels. We look at it from the points of view of governments or sovereign countries; corporate entities; and individuals or households.

At each level there are two aspects that we consider. First, what are the implications for financial stability oversight? We look for vulnerabilities that could lead to pressures on counterparties, with the possible failure of institutions and ultimately financial instability. Such crises can lead to immense social and economic cost, as financial intermediation is disrupted and confidence in the monetary system is weakened.

Second, we look at debt from the point of view of monetary policy. In this case we look at the possible impact on our ability to meet the inflation target set by the Chancellor via, for example, its effect on overall levels of demand and supply.

At the level of sovereign entities we have two different types of concern about the working out of sovereign debt positions. First the potential implications of sharp exchange rate movements for countries that borrow in their own currencies (for example the USA). Second for countries that borrow large amounts in foreign currency concerns about debt sustainability which lead to our working on crisis prevention and resolution issues in the sovereign area, including the role of the IMF and issues raised by the present Argentinean default.

At the corporate level, the question you all face is what amount of debt is not only sustainable, but will lead to maximisation of shareholder value over time? Here our interest is in trying to spot vulnerabilities, or debt concentrations across the market place, which could give rise to problems down the track. In the face of shocks such factors could have an impact on demand in the economy and on the stability of the financial system.

Household Debt: Introduction

It is the third level of our interest - household debt – which I would like to focus on today. It is clearly significant for all of us. For you in the corporate world through your customers. And for us in the world of public policy.

I would like to examine, first, why has debt built up in the way it has? Second, what are the facts and how great are the vulnerabilities? And, third, what are the implications for those of us involved in financial stability oversight and monetary policy, quite apart from society as a whole?

The Household Debt Build-Up: Why Has It Happened?

It is worth reflecting on why the build-up in household debt has occurred. On one side there have been a series of demand factors. Lower real and nominal interest rates have held out the prospect that interest costs and debt-servicing burdens will remain within acceptable bounds – in terms of the burdens on both real incomes and households' cash flows. And lower inflationary expectations have held out the prospect that nominal interest rates will remain low. The lower inflation environment has also increased predictability and made it easier for households to plan ahead. Risks seem more acceptable to households because of confidence in a stable economy, and secure job prospects, perhaps in part due to the current accommodatory monetary policy.

In the meantime, wealth has risen and stocks of financial assets have built up. In the light of this, it is not surprising that households, taken together, are happy to have higher debts relative to their incomes. And the rise in house prices, combined with a high level of owner occupation, has encouraged equity-enabled homeowners to borrow accordingly. These factors have given households the confidence that present levels of debt are quite rational from the point of view of their balance sheets. In addition, the rise in house prices has itself necessitated an increase in borrowing as the average mortgage size increases.

There have been supply-side factors too. Competition amongst lenders has been intense. There have been new entrants to the market. Not only the traditional lenders but specialist providers of credit cards and the like. Liberalisation of markets has meant new approaches to lending and new credit instruments, enabling credit to be available to a wider variety of participants and reducing credit constraints.

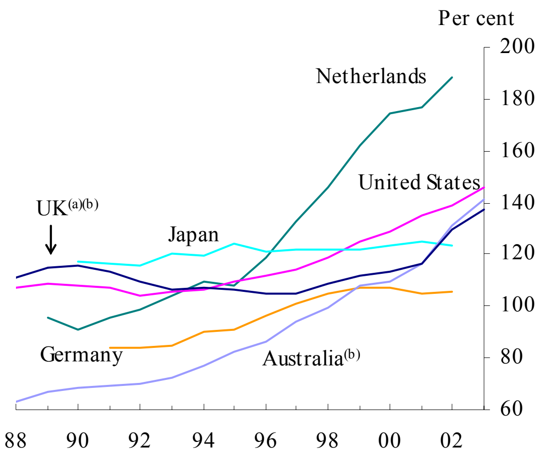
I will come to the vulnerabilities in a moment, but overall this combination of demand- and supply-side factors has led debt to rise to today's historically high levels.

The Debt Build-Up: What Are the Facts? How Great is the Vulnerability?

It is not just in the UK that domestic indebtedness has risen: its build-up, alongside globally lower levels of inflation, has been a global phenomenon. The ratio of household debt to annual household income has increased in most industrial countries

– reflecting over the longer term increased financial liberalisation, the greater efficiency of financial intermediaries and, in some countries, housing market developments. While the ratio in the UK is high, at over 130%, there are other countries where it is higher, and where it has grown more quickly.

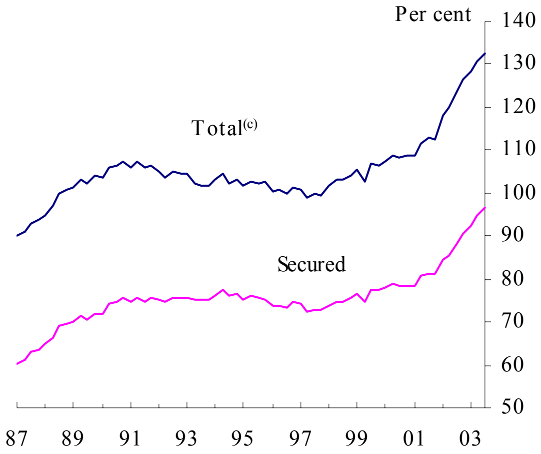
Chart 1:
Household debt-to-income ratios



Sources: Eurostat, national central banks and statistical agencies, and Bank calculations.
(a) Ratio differs from that in Chart 2 because disposable income used here is not adjusted for changes in net equity in pensions.
(b) Data for 2003 are as at 2003 Q3.

In the UK household debt to income amounts to just under 18 months worth of household disposable income. Mortgage debt is the biggest component of this, and total secured debt accounts for about 75% of total debt. Unsecured debt – personal loans, credit card debt and the like – is still a much lower proportion, but has nearly doubled over the past decade.

Chart 2:
Consumer secured debt and total household debt as a proportion of post-tax income[(a)(b)]

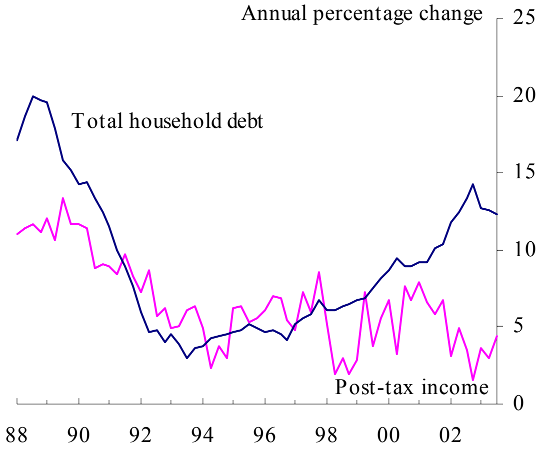


Sources: ONS and Bank Calculations.
(a) Annualised household post-tax income.
(b) Debt data are not seasonally adjusted.
(c) Total household debt.

The actual statistics of stocks and flows are of course one thing. But the real question is in relation to sustainability: sustainability of debt servicing burdens and sustainability of consumption growth.

Household debt in the UK has been increasing more rapidly than post-tax income since the end of 1997, and the difference in annual growth rates over the past year has been around eight percentage points. This has been one of the factors which has permitted consumer spending growth to outstrip income growth on average over the past few years. Mortgage equity withdrawal, in particular, has risen sharply relative to consumption. Some of this will have helped to finance consumer spending even though much is used to pay off other debts or build up other assets.

Chart 3:
Twelve-month growth rate of total household debt and post-tax income

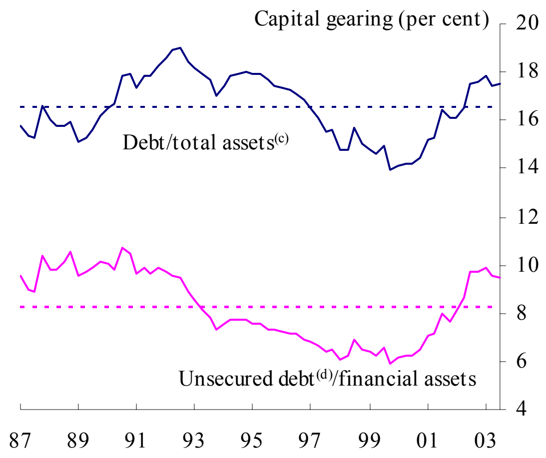


Sources: ONS and Bank calculations.

We also consider questions of gearing. First, <u>capital gearing</u> – the ratio of debt to gross assets - changes in which one can regard as a rough and ready indicator of pressures on solvency in the household sector.

It is perhaps noteworthy that despite the large increase in debt, the increase in asset prices, not least house prices, has meant that there has been only a slight increase in capital gearing. But the data do suggest that household capital gearing could rise to historically high levels if there was, for instance a sharp downturn in the housing market or a significant fall in equity markets. I'm not saying that these are <u>likely</u> to happen – simply that there is an upside risk to households' capital gearing.

Chart 4:
Household sector capital gearing[a][b]



Sources: ONS and Bank of England.
(a) Dashed lines indicate averages of series from 1987 Q1 to 2003 Q3.
(b) Data are not seasonally adjusted.
(c) Financial wealth plus housing wealth.
(d) Total debt minus lending secured on dwellings.

Second, we need to look at income gearing. Changes in aggregate income gearing provide a crude proxy for pressures on households' ability to service their debts, although such measures do not take account of who benefits from the interest receipts.

Having peaked in 1990, aggregate household income gearing fell sharply, mostly reflecting the fall in nominal interest rates, and it has been steady since 1993 at a relatively low level. If, as we expect, debt continues to grow faster than income, as a result of turnover in the housing market, income gearing in the UK will rise in the future – even on the conditioning assumption of constant interest rates which the Monetary Policy Committee makes in its inflation projection. If, for the sake of argument, one takes the future path of interest rates implied by market yield curves – the path expected in the markets – income gearing is likely to pick up towards the peak last seen in 1990 particularly if, in addition, one takes account of regular repayments not only of mortgage principal, but also of unsecured debt. The possible build-up in income gearing could under this scenario require vigilance.

So overall, we may not have an absolute answer about whether today's levels appear sustainable. I feel, however, that since there are at present relatively high levels of debt and these are rising faster than income, it is likely that potential vulnerabilities from increased gearing are rising. And we know from experience that unexpected shocks from one source or another can upset individuals' predictions and behaviour.

Does It Matter? The General Approach.

The question is does this all matter? Should we really worry about it? Perhaps I can get into this by examining the two schools of thought.

On the optimistic side, as I referred to earlier, you can argue that the rise in debt is a logical response to a more stable economic environment and the relaxation of credit constraints. Households consider the wisdom of given levels of debt after taking into account their assets and prospective income. House prices and the value of financial assets have risen. Accordingly some rise in debt is quite understandable and for many house buyers necessary.

In addition, it is a logical response to a number of factors. First, the lower initial cash-flow costs of servicing in the low-nominal-interest-rate environment of the past decade. And second, to the lower real interest burden recently as monetary policy has reacted to weaker aggregate demand growth. And it is understandable for households to wish to spread consumption over their lifetimes. Furthermore, from an overall macro-economic point of view, the increase in household spending financed by borrowing has been consistent with overall monetary stability and our inflation target because other elements of demand have been weak. In other words, it has been a logical accompaniment to monetary stability at a time of imbalances in the composition of the growth of demand and has reflected an 'acceptable' imbalance needed to keep the economy growing.

The pessimistic school points first to the fact that leverage adds to vulnerabilities. There will always be unexpected shocks, and levels of debt are at historical highs and rising. Second, it warns that reliance on wealth to justify levels of debt and provide the collateral can be a circular argument. Demand for housing itself has to an extent been increased by the availability, at the time that it is contracted at least, of affordable credit. Increases in house prices and secured debt have tended to reinforce each other. If either has 'overshot' – for instance, because of unrealistic expectations of income growth – the other is likely to have overshot too.

And, third, there is a timing issue. Perhaps the borrowers' realisation of the implications of higher debt take time to sink in. When interest rates are falling– the case in the UK in terms of our repo rate from February 2001 to July last year – borrowers may feel better placed to service higher loans and might increase borrowing accordingly. However, if rates rise – as they have at the official level – the cost of servicing the outstanding debt will tend to rise and can cause repayment difficulties.

While there are elements of truth in both schools of thought, the balance of probability lies with the optimists. The optimistic school reflects the central case, whereas the pessimists are more inclined to focus on the risks – the tail of the distribution if you like. But even if the probabilities of things going wrong in the near future may not be high, there are nonetheless credible threats, and over time the risks might mount.

Remembering our public policy role, I would like to drill down a bit and ask the question "does this matter?" from three aspects: financial stability; monetary policy; and the socio-economy.

Financial Stability Issues

First financial stability, the oversight of which is one of the Bank's key responsibilities. Here we need to focus on mitigating the potential impact on the financial system from vulnerabilities that might arise from high levels of debt. Will they give rise to concerns over repayment strains, to financial failures or liquidity withdrawal? Could strains lead to defaults of multiple borrowers, leading in turn to problems for the intermediaries and providers?

From the point of view of lenders I detect that there is on the whole a feeling of confidence, with few overall concerns about the asset portfolios of secured and unsecured household debt. There has been a significant improvement in risk management systems: at the retail level, for example, information technology has enabled the development of sophisticated modelling techniques. Data suggest that: UK-owned banks' capital ratios are strong by international and historical standards; that the proportion of new mortgages granted at high loan-to-value ratios has dropped; and that the loan-to-value ratios on existing mortgages have fallen. Mortgage arrears are around their all-time low. Such factors help to boost the resilience of the United Kingdom's financial system.

There are, however, potential hazards - in particular relating to poor lending decisions or to changes in the behaviour of borrowers. There have been examples in other countries, for example the US, of potential changing attitudes to personal bankruptcy and defaults. Under some scenarios, such changes could put pressure on the balance sheets of lenders. Furthermore, it is possible for the behaviour of lenders to trigger a response in borrower behaviour. If lenders get nervous about the credit status of borrowers, and turn off the supply of credit, this could cause failure or default of borrowers. The lenders seek to anticipate such issues, partly by pricing expected losses into the lending products they offer and also through the development of risk management tools and stress testing. The strength of the financial system is increasingly reliant on the effectiveness of risk management.

As I mentioned earlier, there is a potential concern that the wealth itself, on the basis of which increased indebtedness has been made possible, may not be wholly dependable. It could be affected greatly by, for example, a downturn in the housing market, or by difficulties in the corporate sector triggering a reduction in people's wealth via their direct or indirect holdings of shares. Not everyone will be affected by the same scenarios, but a reduction in wealth could reduce an ability or willingness to repay debts and at the same time reduce lenders' access to collateral.

So, with all these caveats, just what are the implications of this for the oversight of financial stability? First, of course, we need to be vigilant and watch for emerging signs of weakness. But, second, there are a number of mitigants. We can give warnings to enhance awareness of the implications of the indebtedness increasing. The financial system itself can be strengthened through adherence to a high quality prudential framework. That is why the current review of the Basel Capital Accord is so important. Remember that this is designed to improve risk assessment by lenders, not just at the wholesale level but at the retail level as well. And risk management techniques and supervisory processes more generally are in the process of significant enhancement.

In earlier days one might have considered other potential mitigants. These might have included credit controls or deliberate prudential measures increasing the cost of lending. The fact, however, is that with today's liberalised capital markets and with the existence of derivatised products these would in all likelihood be rendered impractical.

Monetary Policy Issues

Turning to monetary policy, the key focus is the extent to which vulnerabilities from the debt build-up could trigger changes to demand or supply in the economy with direct implications for monetary stability and meeting the inflation target.

Higher levels of leverage could make demand more susceptible to external shocks which might lead to precautionary saving: this in turn could reduce demand. Equally, socio-economic factors could also cause changes in behaviour, even though these might be more gradual and are unlikely to affect all members of society at once.

In assessing the potential impact of debt build-up on demand and supply, there seem to me to be several important factors. First, is the fact that demand in general is boosted by increases in asset prices themselves. But what would happen if external events broke the cycle of asset price increases, particularly in relation to house prices? A sudden realisation that the wealth cushion supporting levels of secured debt was deflating could trigger behaviour that would reduce demand.

Second, for some people consumption has been growing more rapidly than disposable income, and some of the increase is likely to have been financed by increased borrowing. If such people decided to readjust their balance sheet this could impact on demand.

Third, precautionary saving could increase – for example, if households decide they need to make greater provision for their future retirement income. This could alter the desire to take out or to repay debt. Although this would only be likely to affect a particular part of the population, the extent of its impact would be hard to assess in advance.

This, of course, is of direct relevance to monetary policy. Changes in the level of debt can result in changes to demand, and also to the level of vulnerabilities. These in turn have an important bearing on the state of the economy. And the higher the leverage, the greater the vulnerability to any given shock becomes. Furthermore, the price of, and hence demand for, new debt will be affected by the policy decision itself. Demand might also be affected by the impact of the decision on people's expectations about future rate movements.

It may be true that we do not fully understand the transmission mechanism that could lead to changes in demand. Even though the price of debt is directly influenced by overall interest rate levels, we cannot evaluate with precision how much effect a given change in interest rates will have on levels of debt. But we do watch this from month to month, and are quite well positioned, thanks to the data we regularly look at, to judge the emerging impact of policy decisions.

It is important to remember that we need to consider the fulfilment of our monetary policy remit over time. Not just over the next two years for which our forecast is given, but over the longer term as well. Sudden unexpected shocks of course could threaten monetary stability and might make keeping to the target trickier. We need to ensure that threats of instability from such a shock do not call this into question.

With this in mind, each month when we on the MPC make our policy decision I am conscious of the debt situation. In particular the possibility that the potential vulnerabilities stemming from higher debt levels do in fact crystallise at some point and trigger a sharp demand slowdown that could have an adverse impact on monetary stability and make it more difficult to meet the inflation target over time.

So in considering the whole gamut of demand and supply data that we receive and evaluate, I do allow these factors to weigh in the difficult balance all of us face each month in relation to the monetary policy decision. I mentioned my tendency to think about the risks, however conscious I am of the central case. And this explains why on several occasions over recent months I have found myself voting for a rise; with a view to discharging our mandate to stabilise inflation at the target level, with stability in the monetary arena.

Conclusion

I have focused this morning on the issues that are of direct relevance to the Bank's own remit: monetary and financial stability. But a discussion on household indebtedness would not be complete without a brief mention of the significant longer term socio-economic issues, which I certainly give thought to, raised by demographics and a longer living population.

On the one hand we can see, as discussed, many households increase their borrowing levels, encouraged as this is by willing lenders, low inflation and interest rates, and social acceptability. On the other hand people are increasingly going to be confronted, at some stage in their lives, by the realities of the need for extra saving to cater for pension provision, long term care provision, and increased longevity.

The question is how can these two factors be reconciled without a significant impact on the real economy? Or will today's generation in effect transfer leverage to the next generation – calling into question the issue of intergenerational fairness? The reconciliation could be exacerbated, given the demographic trend of smaller numbers entering the job market. We can certainly hope that the issue can be resolved by gradual adjustment over time without a significant impact on monetary and financial stability.

But this aspect of the socio economic scene provides a real dilemma. It is not a short term issue, and not one that is for MPC. But the issues will surely be addressed and the contribution that we can make is to provide a stable and economic and financial backdrop against which this can be done.

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