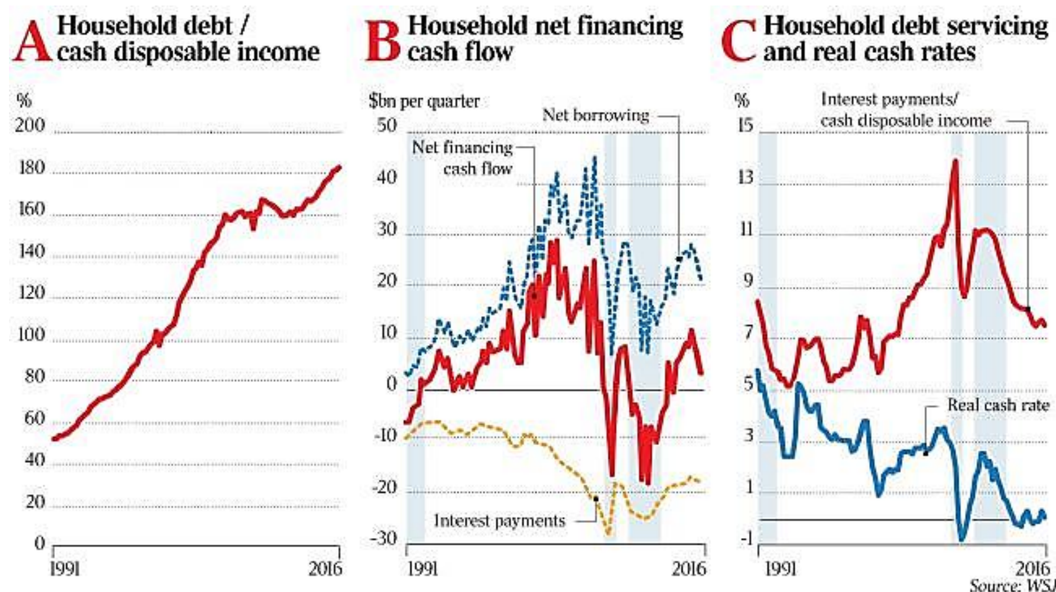
Economy at risk from soaring household debt levels



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Household debt has grown substantially over the last quarter century, with debt accumulation far outstripping interest payments in most quarters.

Leveraging up by households has boosted their cash flows by almost $600 billion (in today's dollars) over that time — equivalent to 3.1 per cent of cash disposable income. However, there is a downside: households — and our economy — are now more exposed than ever to an inevitable rebound in real interest rates.

Household debt has grown much faster than income (Chart A), rising from 52.6 per cent of cash disposable income to 183.2 per cent in 25 years. Of course, rising debt is normal in any expanding sector, and some of the growth in household leverage may reflect a greater willingness of lenders to provide credit based on assets and expected future incomes.

However, lower real interest rates also encouraged households to borrow, which in turn drove up house prices; the resulting increase in collateral values enabled households to borrow more again.

There are two possible interpretations of the current situation. First, households have leveraged up based on rational expectations of future interest rates or stronger growth in disposable income; if so there's no problem (if those expectations prove accurate). Second, low real interest rates have generated over-leveraged households, inflated house prices and a risky future ahead.

The second interpretation is very plausible, given the extent that households have leveraged up against cash disposable income. Some households may have extended themselves to the point where their savings from income are insufficient to meet interest payments; they rely on ongoing rises in collateral values so they can borrow more to service existing debts. A classic Ponzi effect associated with most historic asset price bubbles.

When their net borrowings (new borrowings less principal repayments) exceed interest payments, households receive a net financing cash inflow. The converse — interest payments exceeding net borrowings — has occurred in successive quarters only three times in the past quarter-century (Chart B).

In each case, the resulting cash flow drag on households contributed to the Reserve Bank's slashing of nominal cash rates, resulting in real (inflation-adjusted) cash rates falling by 5.9 per cent over three years in the early 1990s, 3.2 per cent in a year in 2008-09 and 2.4 per cent in the three years to mid-2013. In each case, real interest rate

cuts made household debt easier to service in the short-term (Chart C); however, this in turn encouraged households to resume their debt accumulation.

Of course, interest rates directly affect households' debt servicing ability, as Chart C illustrates. However, the growing gap between the two lines reflects the substantial growth in debt relative to cash disposable income, making households more susceptible to rate rises.

Interest rate cuts raise household cash inflows for a while because they reduce interest payments and raise borrowing. However, the impact diminishes over time, as the induced additional initial borrowing raises interest payments and reduces the rate of new borrowing.

Therefore, household cash crunches can occur even in periods of stable rates that follow rate cuts. For example, after rate cuts in February and May of 2015, the Reserve Bank kept the cash rate steady at 2 per cent during the first three-quarters of 2015-16. The prior rate cuts flowed through to boost borrowing and reduce interest payments in the first quarter.

However, by the third quarter, with households already leveraged up, interest payments had risen, and new borrowings had fallen. Consequently, while households' net financing cash inflow was still positive in the third quarter (at $5.9bn), it had fallen by $5.1bn (46.6 per cent) since the first quarter, to its lowest level in almost two years. This fall significantly dented households' overall cash flow (cash disposable income plus net financing cash flow) — and the Reserve Bank soon cut interest rates by 0.25 per cent in May and again in August.

But the real problems kick in when interest rates inevitably rise from historically low levels (Chart C). Given continued improvement in the US economy and expectations of continued increases in US interest rates, forward markets now expect Australia's cash rate to remain steady at 1.5 per cent until early 2020 and then rise to 2 per cent by the end of 2021.

We project that if these forward market expectations are correct, households will experience a cash flow drag totalling $179bn between now and the end of 2021 — equivalent to a 3.7 per cent cut in cash disposable income. While recent rate cuts probably boosted cash inflows in the September quarter, we project that households' net financing cash flow will reach negative territory after mid-2017.

Given our historically high ratio of household debt to cash disposable income, even small rate rises (totalling 0.5 per cent in 2020 and 2021) will further deepen the household cash crunch by raising household interest payments and slowing new debt accumulation.

In the past, the Reserve Bank has been able to respond to such cash flow drags with rate cuts. However, the rate-cutting cupboard is almost bare, and the Reserve Bank will likely follow US rates up to avoid a currency crisis and resulting inflationary pressures. Therefore, the rise of household leverage now poses significant potential downside risks — not only for households, but also businesses with high exposure to households (such as discretionary retailers) and our overall economy.

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