Puzzles in today's economy

To what extent can current levels of household debt affect our financial stability, asked Sir Andrew Large in the opening speech at The Treasurers' Conference.

Leverage and debt: benefit and 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 Long Term Capital Management (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. 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 ultimately to 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.

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.

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.

– the build up of household debt

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' cashflows. 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. 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.

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. 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 (see *Figure 1*).

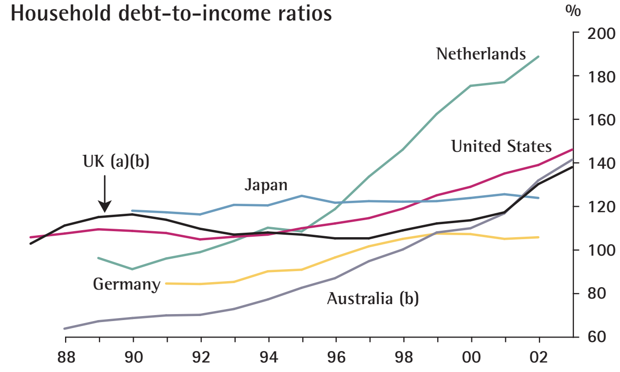
In the UK, household debt to income amounts to just under 18-months worth of household disposable income. Mortgage debt is the biggest component of this, and total secured debt accounts for about 75% of total debt. Unsecured debt – personal loans, credit card debt and the like – is still a much lower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

It is also important to consider the 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 (See *Figure 2*).

We also consider questions of gearing. First, capital gearing 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 does suggest

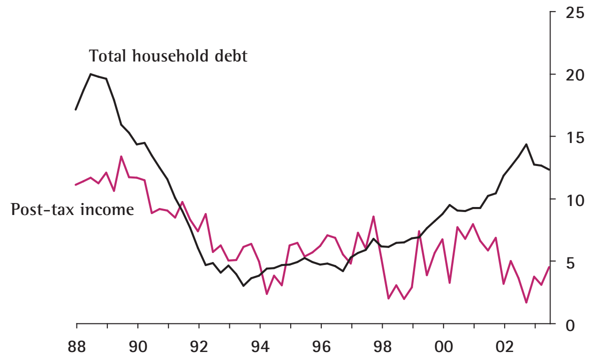
Figure 1
Household debt-to-income ratios



(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.

Sources: Eurostat, national central banks and statistical agencies, and statistical agencies, and Bank calculations.

Figure 2
Twelve-month growth rate of total household debt and post-tax income



Sources: ONS and Bank calculations.

So what are the implications of this for the oversight of financial stability? First 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. 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. 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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