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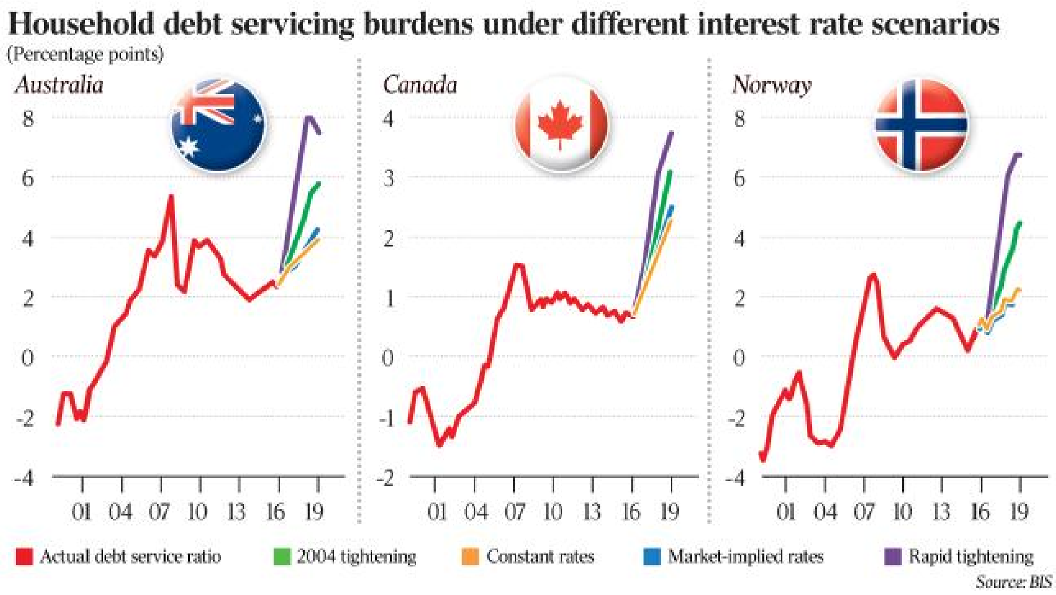

Booming household debt has a sting in the tail

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Australia will pay a price for its household debt boom through lower future growth, even if it avoids a housing debt bust.

The Bank for International Settlements believes Australia and Canada, which both avoided banking failures during the global financial crisis, are among the countries most at risk.

With the US leading what is expected to become a global lift in interest rates, the burden of servicing household debt could rise sharply.

The BIS annual report, released today, draws on an emerging body of academic research highlighting the links between household debt and subsequent underperformance.

"Household debt — or debt more generally — outpacing GDP growth over prolonged periods is a robust early warning indicator of financial stress. Further, there is growing evidence that household indebtedness affects not only the depth of recessions but growth more generally," it says.

A study by BIS economists covering 54 economies over the past 25 years found that a percentage point increase in the household debt-to-GDP ratio lowers growth in the long-run by 0.1 percentage point.

"The negative long-run effects on consumption tend to intensify as the household debt-to-GDP ratio exceeds 60 per cent. For GDP growth, that intensification seems to occur when the ratio exceeds 80 per cent."

In Australia, the ratio of household debt to GDP surpassed 80 per cent in 2003 and currently sits at 123 per cent, which is second only to Denmark. The debt to GDP ratio rose by 10 percentage points between 2013 and 2016.

BIS research attributes the influence of housing debt on economic growth partly to simple shifts in cash flows. While a boom is under way, household incomes are being boosted by the additional debt.

However, once the growth in debt peaks and starts to ebb, the debt service burden becomes a drain on household cash flows.

The impact on cash flows is obviously more significant as interest rates rise. In the event of a 2.5 percentage point increase in interest rates, the debt-service ratio in Australia would jump by 5.2 percentage points. The BIS says that two-thirds of financial crises are associated with rises in debt-service ratios of that level.

The BIS believes that a significant deviation of debt-service and credit-to-GDP ratios from their long-term average are good early warning signals of financial distress.

In Australia, credit to GDP is 0.5 per cent below its long-term average, due mainly to subdued business borrowing, while debt service ratios are only 1.3 per cent above their long-term average, which is considered benign. Canada would fare even worse than Australia under the impact of a 2.5 per cent rise in interest rates, generating a 7.6 percentage point rise in the debt-service ratio.

An intriguing finding in the BIS study is that the effect of a household debt boom on growth is greater in countries such as Australia that provide creditors with stronger legal protection.

During the US subprime crisis, borrowers simply walked away from homes worth less than their mortgages, leaving creditors with the problem. The BIS says that household borrowers are less likely to default in countries with stronger credit protection, but the impact of servicing their debt will reduce consumption growth by more.

The BIS cites a forthcoming paper from economists, led by Princeton University's Professor Atif Mian, which has tracked the relationship between housing debt and economic performance across 30 nations between 1960 and 2012.

They found that during a housing debt boom consumption to GDP ratio increases and imports of consumption goods rise. However, the boost is temporary. Over the following three to four years, GDP falls. A 6 percentage point increase in the household debt to GDP ratio over the final three years of a boom is associated with a 2.1 per cent decline in GDP over the next three years.

The study finds that this effect is not appreciated by economic forecasters. It looked at IMF and OECD economic forecasts over the past 40 years and found they were consistently too optimistic about the growth generated during a housing boom continuing into the future.

"Neither the IMF nor OECD adjust their forecasts downward after seeing a rise in household debt from four years ago to last year."

The study debunks the theory that housing debt booms are a rational response by households to expectations that their future incomes will rise. Were this the case, rising demand for credit would drive interest rates higher.

In reality, the study finds housing booms are associated with falling spreads between mortgage rates and underlying interest rates. It is excess supply of credit, not excess demand for it, that drives debt booms. The finding on spreads does not tally with recent experience in Australia. However, this has been muddied by the impact of the global financial crisis on bank funding costs, which have pushed interest spreads higher generally.

The study's finding is consistent with the lower absolute interest levels in Australia, with standard mortgage rates coming down from 7.4 per cent in 2012 to 5.3 per cent now under the influence of the RBA rate cuts.

The Mian paper establishes that it is the ratio of household debt to GDP, not house prices, that are the predictor of lower subsequent output growth.

Although credit booms can be halted by external factors, they can also reverse of their own accord. "While the exact timing of the reversal is not known, a rise in credit supply driven by lender optimism eventually reverts as lenders become pessimistic."

The paper finds that rises in household debt are typically reversed within three to seven years.

In Australia, the housing boom has not been accompanied by a surge in consumption as the studies cited by the BIS suggest. Consumption has been repressed by weak wages growth — even in NSW, which has been at the heart of the housing debt boom.

However it is plausible that the consumption would have been weaker were it not for the surge in debt and will still be vulnerable once the boom has passed.