# Assessing risks to financial stability and macroeconomic stability from household debt

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# Household debt and risks to financial stability

- Household debt serves an important role in the economy and provides crucial services to households
- Household debt becomes a problem, if households have difficulties servicing their debt (interest, amortization, and repayment of principal at termination of the loan)
- Such difficulties may be caused by negative shocks, such as housing-price falls, interest rises, and income falls
- Lenders may suffer credit losses, which, if too large, may imply a threat to financial stability

# Finansinspektionen (FI, the Swedish FSA) on Swedish household debt and risks to financial stability:

- "FI's current assessment is that the financial-stability risks associated with households' debt are relatively small.
- … This is because the mortgagors generally have good potential to continue to pay the interest and amortization on their loans, even if interest rates rise or their incomes fall.
- …On average, the households have comfortable margins with which to cope with a fall in house prices.
- …Swedish mortgage firms are also deemed to have satisfactory capital buffers should credit losses still arise."

# Assessing risks from household debt to financial stability

- Assessing lenders' resilience to shocks:
  capital buffers, liquidity buffers, lending standards,…
- Assessing borrowers' resilience to shocks:
  debt-servicing capacity; resilience to housing-price falls, interest-rate rises, and income losses because of unemployment
- Assessing quality of collateral:
  Whether or not housing is overvalued: user cost/income, housing payment/income, user cost/rents, expectations of future housing prices and interest rates, speculation,…
- Stress tests on both lenders and borrowers

# Household debt and risks to macroeconomic stability

- When negative shocks occur, households may continue to service their debt but cut down on their consumption (especially when debt is “full recourse”)
- Such behavior may not be a direct threat to financial stability, but it reduces aggregate demand and may add to an economic downturn.
- If household debt is such that there is a risk of macroeconomically significant spending cuts if negative shocks occur, household debt may imply a risk to macroeconomic stability (especially if monetary policy is restricted by the effective lower bound on the policy rate)

# Assessing risks from household debt to macroeconomic stability

- Arguably more difficult to assessing risks to macroeconomic stability than to financial stability
- High household indebtedness suggested as a major factor behind the severity of the recent financial crisis
- Microdata evidence of correlation between pre-crisis household indebtedness and subsequent spending cuts (Denmark: Andersen et al.; UK: Bunn & Rostom; US: Mian & Sufi, Dynan; …)
- But correlation is not causality
- What is the mechanism?

# Understanding the mechanism is important for the risk assessment and for macroprudential policy

- If high household indebtedness cause a risk of spending cuts, macroprudential policy that reduces household indebtedness may have the benefit of reducing macroeconomic risk
- If not, such policy may have no benefits but significant welfare and distributional costs, for example, make it more difficult for households with low to moderate incomes and wealth to find suitable housing
- Mistaken policy may even be counterproductive and make any macroeconomic risk higher

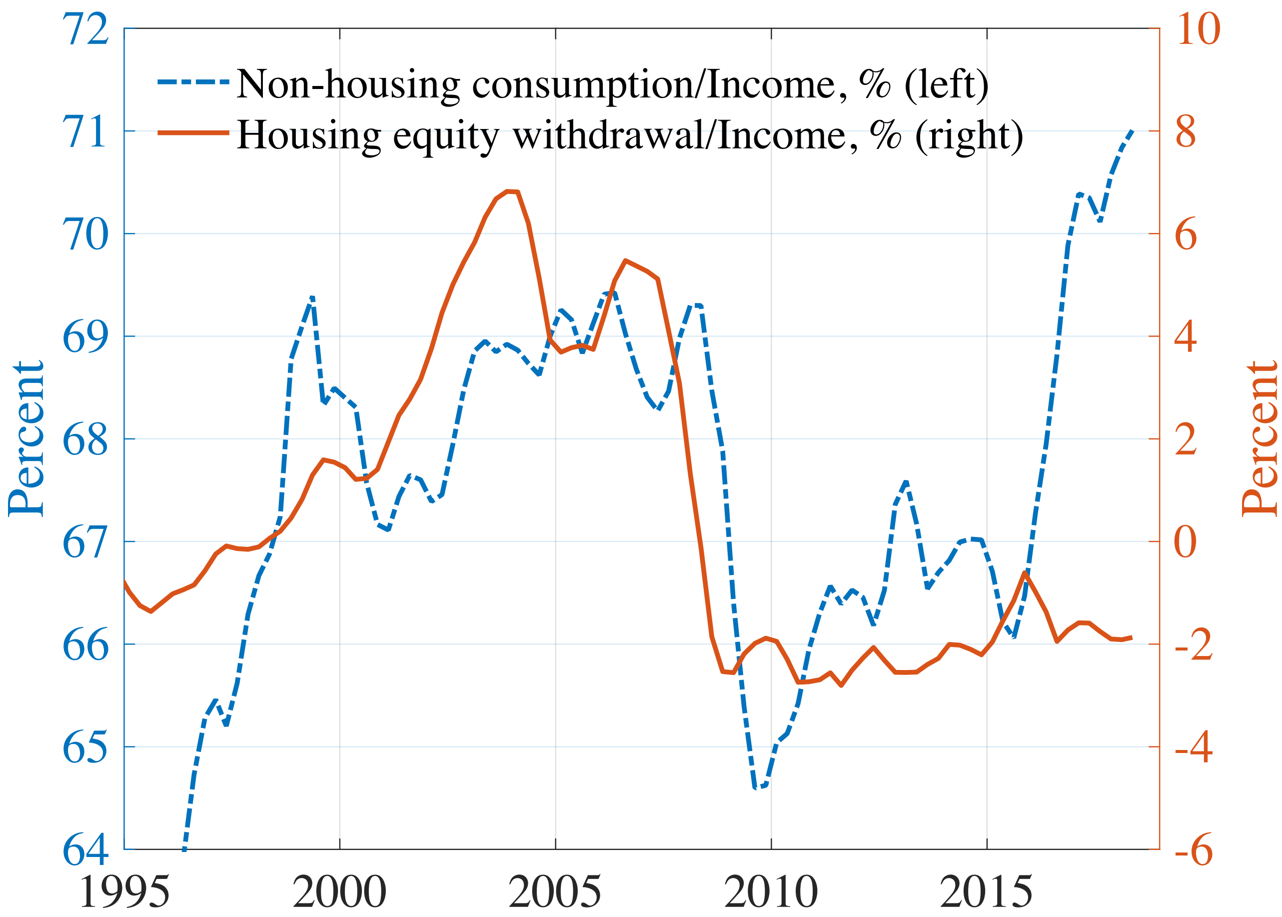
# The evidence is that there is no causality but a common factor, debt-financed overconsumption

- In Denmark, UK, and the US, when housing prices rose before the crisis, households increased their mortgages (housing equity withdrawal, HEW) to finance an unsustainable overconsumption (undersaving) relative to disposable income (Muellbauer: "housing collateral channel," Mian &Sufi: "debt-driven household demand channel")
- When the crisis came, this HEW and overconsumption could not be maintained
- Highly-indebted households reduced their consumption back to normal relative to disposable income; less-indebted household adjusted their consumption much less
- Debt-financed overconsumption explains both high household indebtedness before the crisis and spending cuts during the crisis

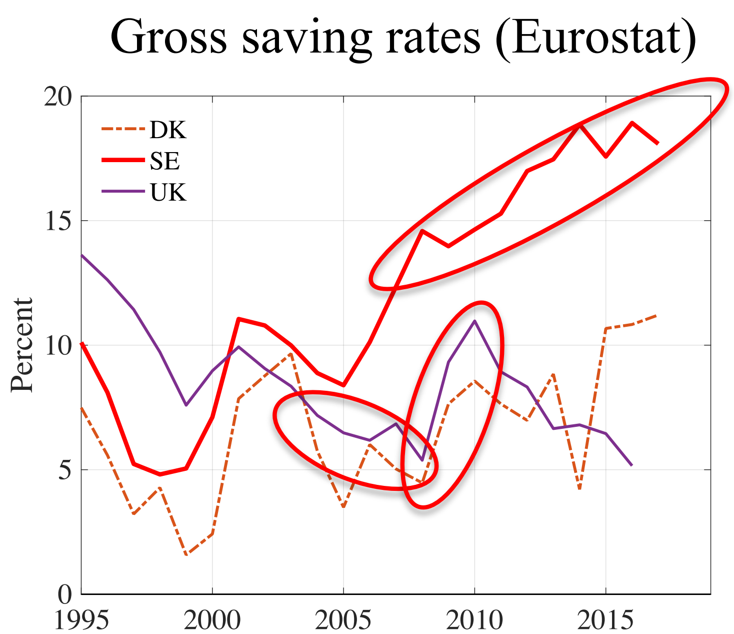
## Macroeconomic risk assessment: Evidence of debt-financed overconsumption (macroeconomic significance)

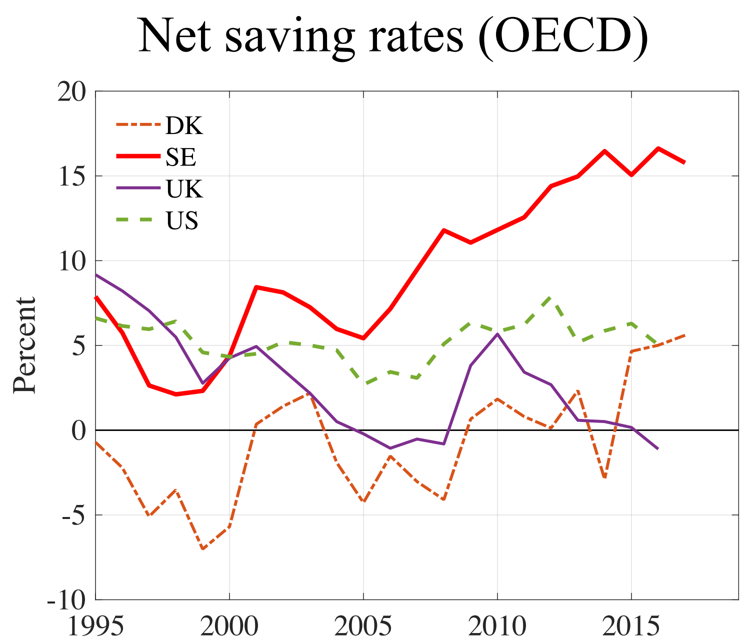
- Strength of housing-collateral channel varies across countries (Muellbauer: weak in Germany, Italy, France; strong in Ireland, Spain, UK. Me: weak in Sweden)
- Shows up in a low aggregate household saving rate and high durable-goods consumption
- Examine relation between aggregate HEW and consumption
- Look for micro-evidence of HEW and any use for unsustainable overconsumption

# Example: Aggregate HEW and non-housing consumption to disposable income, UK



# Example:
# Saving rates in Denmark, Sweden, the UK, and the US




- This and other evidence implies for Sweden:
- No evidence of any debt-financed overconsumption (undersaving)
- No evidence of an "elevated macroeconomic risk" (contradicting FI)
- No rational for FI's mandatory amortization requirements
- Counterproductive: Reduce resilience. Increase risks. Have large welfare costs.
- See: Svensson (2018), "Housing Prices, Household Debt, and Macroeconomic Risk: Problems of Macroprudential Policy I," https://larseosvensson.se/