

Is credit growth sustainable?

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Introduction

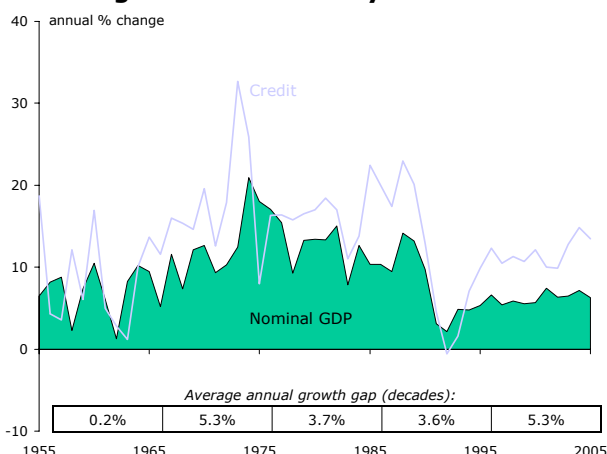
This paper addresses one of the key issues facing the financial services sector in the coming decade.

- With the brief exceptions of mid-1970s oil price shock and the early 1990s recessions, growth in private sector credit has consistently exceeded nominal GDP growth by a wide margin in the past 30 years. In particular, the boom in *household* credit since the mid-1990s has lifted household debt levels sharply.
- This has led to serious concerns over vulnerability of the household sector and the sustainability of household debt accumulation.

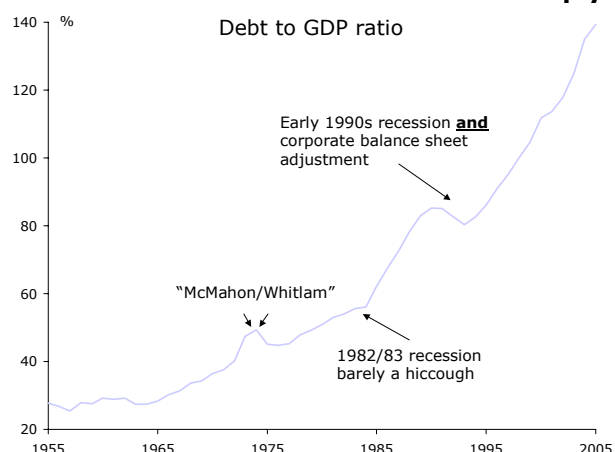
Total credit growth

The Australian experience suggests that nominal GDP, even over long periods of time, has not been a 'reverting' benchmark for credit growth. The hypothesis that 'credit growth must revert to GDP growth' is intuitively appealing and theoretically supportable but empirically unfounded. Given that GDP represents a reasonable proxy for income, it should, correspondingly, represent a meaningful constraint on debt accumulation. But over the past 150 years, credit has, for long periods of time (generational in some instances), grown faster than, or slower than, or at the same rate as nominal GDP with little or no interruption. Recessions, even when associated with balance sheet adjustment (e.g. 1989-90), have acted only as a temporary 'interruption', eliminating the growth premium generally for the length of the slowdown (typically one or two years).

Credit growth consistently exceeds GDP...



...and the debt to GDP ratio has risen sharply



Consequently, the aggregate debt to GDP ratio has risen virtually uninterrupted since the early 1960s. Theory suggests private sector credit growth cannot exceed national income growth indefinitely (due to affordability constraints), however, the historical record implies the existence of significant influences on credit *other than* underlying income growth. These include:

- changes in the regulatory environment,
- structural falls in interest rates/inflation,
- solid gains in asset prices,
- financial innovation/competition,
- behavioural change (rising debt propensities),
- demographic change; and
- extended periods of economic stability.

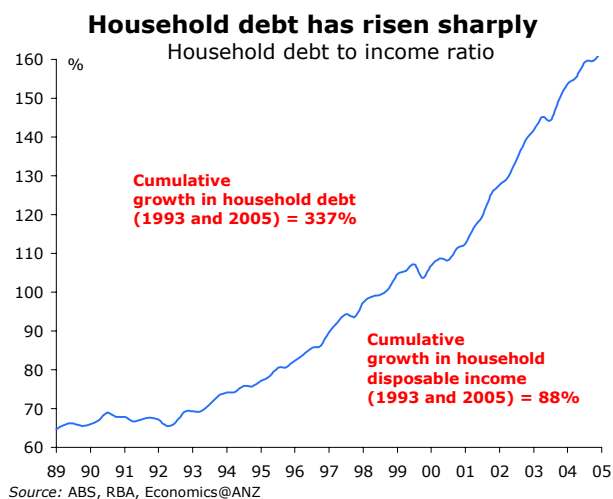
All these factors have been responsible for boosting growth in credit above that of income in recent decades, and in some cases, will continue to do so in coming years.

Household credit

Concerns over 'excess' credit growth have been particularly strong in the household sector. In the past decade, household credit growth averaged a very strong 14.5% per annum, well above growth in household disposable income of just 5.2% per annum. The associated sharp rise in the household debt-to-income ratio has raised questions over the sustainability of household debt accumulation.

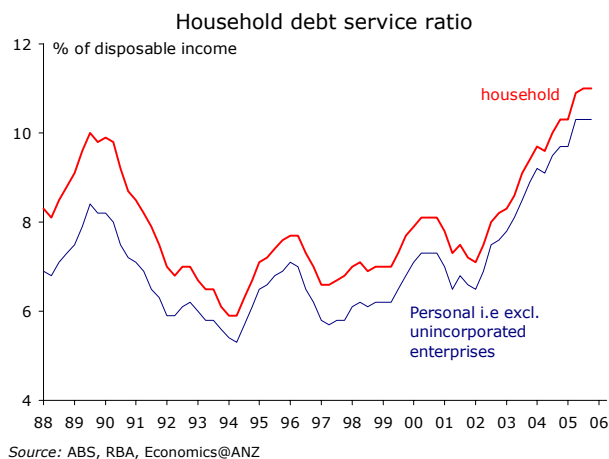
However, in isolation, gross debt-to-income ratios offer little insight and can provide a misleading view of the financial condition of the household sector as they take no account of changing debt-servicing

costs or household sector asset accumulation. Measures such as 'debt-servicing' ratios and 'debt-to-assets' ratios are far more instructive indicators, although these measures too are sometimes leaned on excessively to argue that debt levels are too high and that some correction in household balance sheets is inevitable.¹



A large proportion of the rise in household debt-to-income has been a perfectly rational response to the structural downward shift in interest rates (and debt servicing costs) and an associated gain in house and other asset prices experienced since the early 1990s. Significant economic reform (including industrial relations and fiscal policy) and 14 years of positive and relatively stable economic growth and low inflation have not only lowered interest rates but have also increased confidence that interest rates will remain comparatively low and stable in future. Combined with surging asset prices, this has substantially increased households' propensity to borrow.

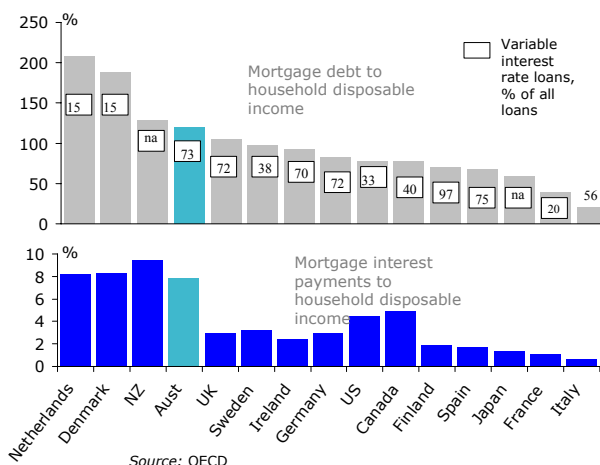
Debt service costs are above previous peaks



¹ "Household Debt – safe as houses" ANZ Economic Outlook, December quarter 2004

As a result, over the past 15 years Australian households have emerged from a position of being 'under-gear'd' (due to a debt-averse culture, financial market regulation and the availability of 'vanilla-only' financial products) to one where they are now far more comfortable with higher levels of debt and where financial service providers are offering significantly more product flexibility.

International comparisons of household debt



Australia now ranks at the high-end of the scale in terms of both 'mortgage debt to income' and 'mortgage debt-servicing ratios'. Broader measures including non-mortgage debt show a similar story. While this should provoke interest and examination, it does not necessarily imply that debt levels are too high. Determining at what level *aggregate* household debt becomes a macroeconomic problem is extremely difficult. The RBA Governor said, in this context, "there does not appear to be a level at which bad things start to happen"².

There is a tendency to look to historical benchmarks and international comparisons in the hope these tell us something about sustainability, limits and vulnerabilities. While these comparisons do go some way to contextualising the current household debt position, they fall short of providing objective criteria for determining critical levels.

While the aggregate household debt service ratio is above its earlier late-1980s/early 1990s peak, the financial stress experienced in the late-1980s/early 1990s had little to do with household sector balance sheets being 'stretched' and more to do with a very highly geared corporate sector. In contrast, at present Australia's corporate sector is in fundamentally sound shape and offers a strong

² "Do Australian households borrow too much?" Address by IJ Macfarlane by RBA Bulletin, April 2003

underpinning for the economy and the labour market.

The most telling evidence that the household debt position remains manageable is the low level of loan arrears. Despite heightened concerns over household indebtedness, loan delinquencies have remained at extremely low levels and in a stable economic and interest rate environment, we believe further growth in household debt levels is both plausible and sustainable.

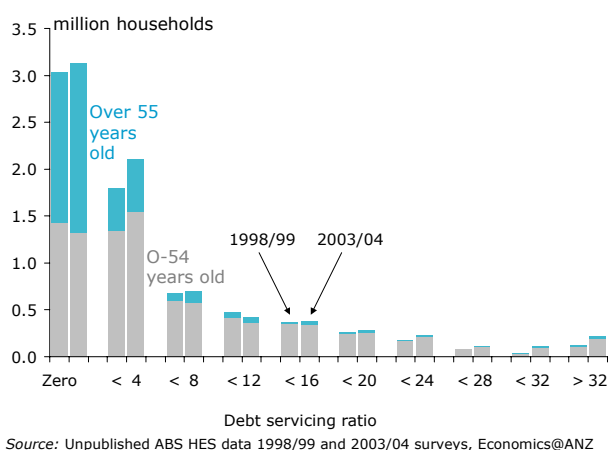
Decomposing household debt

Analysing the distribution of household debt and household characteristics provides us with a far clearer (and more sanguine) view of the sustainability of the recent growth in household credit.

Using unpublished ABS Household Expenditure Survey (HES) data, we have been able to disaggregate the household sector into various 'debt-service ratio' (DSR) ranges and to examine how the distribution has evolved over the 5 years to 2003/04, a period where household debt more than doubled to \$700bn.

The chart below shows that *even after* household debt had more than doubled, around 5 million households (or 67% of all households) *had little or no debt* in 2003/04³. Hence, the household sector's *capacity* to accumulate additional debt remains high.

Most households have little to no debt



The share of households with a mortgage increased from 30% to 35% in the five years to 2003/04. Notably, much of the growth in indebted households has occurred in the low DSR ranges. Further increase in this proportion can raise the

³ 'little' here is assumed to include those with a debt-servicing ratio of under 4% of income

aggregate household debt service ratio further *without necessarily* increasing household 'stress'.

Nonetheless, the number of households in the high DSR ranges also expanded significantly. In part this is a result of decreased housing affordability during the recent housing boom. Homebuyers generally, (and first-homebuyers in particular) now incur a far higher debt service cost, compared with previous decades. While this will tend to raise debt to income and debt service ratios, *in a stable economic environment* there is no reason to expect increased loan delinquency. With a few notable exceptions, bank lending criteria remain conservative and include a significant buffer to allow for potential rate hikes. Loan delinquency rates have remained at low levels despite increased household indebtedness *and* higher interest rates, in large part due to the buoyant economic conditions. In particular, the unemployment rate is near 30-year lows and household disposable income has expanded strongly.

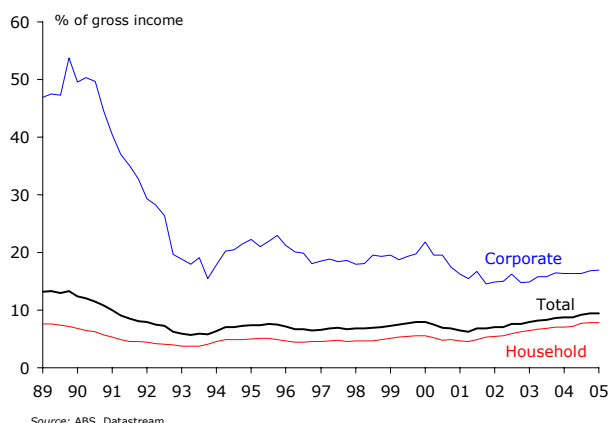
Is the economy more vulnerable?

It is widely argued that the heightened indebtedness of the household sector has left the economy far more at risk in any potential future economic downturn. However, this ignores the substantial reduction in *business* debt after the early 1990s recession, structural improvement in government sector finances and improvement in risk management practices adopted by lenders.

Aggregate private sector debt-servicing burdens remain near historic lows. In particular, business sector balance sheets are in great shape and suggest financial disturbances to business have less chance of flowing through to labour markets and consumer confidence.

Aggregate debt servicing costs remain low

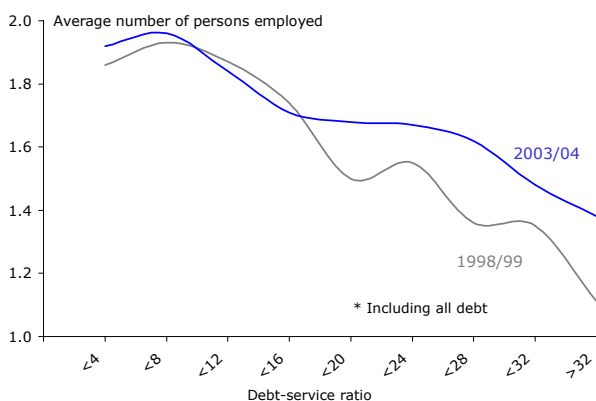
Debt service ratio



There is also a tendency to assume households with higher DSRs are more likely to default on their loans. While 'loss given default' would almost certainly be higher, the *probability* of default is likely to be contingent less on the level of debt servicing burden and more on whether one loses a job or not. This is not to say that there is no positive relationship between DSR level and probability of default but that it is not likely to be *significantly* greater.

Employment loss has serious repercussions in most circumstances but especially in 'one-income indebted' households. HES data suggests there are 2.2 million *one-income* households with debt⁴. For the remaining 3 million '2 or more incomes indebted' households, the consequences of joblessness are less clear depending upon the status of employment within the household and the incidence of unemployment.⁵

Two-incomes help ease the burden
Mortgaged households*



Sources: ABS, Economics@ANZ

The chart above reveals the importance of the dual-income household in alleviating debt-servicing burdens, with a clear negative correlation between DSR level and average persons employed. Interestingly, in the five years to 2003/04, the average number of persons employed in the mid-to-high DSR range households has increased noticeably.

The major incidence of loan default is transmitted through the labour market in the form of job losses. 'Employed' households whose status has not altered, even in recession are likely, on balance, to experience considerably less financial

⁴ Excluding households whose reference person is over 65 years of age.

⁵ For example, 'slightly significant' in the event of say, a lower income, part-time position having been lost for a householder even in a relatively high DSR range to 'very significant' for two full time job losses afflicting a single household that is in a high DSR range.

disruption than households that experience loss of employment. Hence, the increase in the average number of persons employed in the mid-to-high DSR households provides some additional security.

Significant upside for business credit

After languishing through much of the past 5 years, business borrowing accelerated through 2005 and is currently running at an annual growth rate of 17.3%. Yet despite this recent surge in business credit, significant upside remains.

Having peaked at 150% prior to the early 1990s recession, corporate gearing has now returned to pre-deregulation levels. Lower gearing and interest rate falls over the 1990s, have reduced the corporate interest burden from 40% of profits in 1990 to 13% in 2005 (interest cover of nearly 8 times), a level not seen since the 1960s.

Healthy interest cover implies 'business debt to GDP' has considerable scope to go higher without imposing other than a mild up-tick in the servicing burden. Buoyed by the commodity boom, corporate profitability remains at record levels providing a solid backdrop for further growth in business investment and credit in the years ahead.

Conclusion

Our analysis provides a far more sanguine view of household debt levels than that gained from the simplistic interpretation of the aggregate household debt to income ratio. While household debt levels have risen sharply, they are yet to reach critical 'limits' and as long as broad macroeconomic conditions remain supportive, we do not believe a household balance sheet 'correction' is imminent. Ongoing employment and household income growth are far more critical determinants of the sustainability of household credit growth than debt levels or their service ratios.

Nonetheless, in the absence of further major structural change, growth in household debt will eventually revert towards underlying income growth. This process may be accelerated in the coming decade by the ageing of the Australian population as population growth is skewing towards those who have traditionally been mortgage-free. However, this is unlikely to have a significant impact for some years yet. Moreover, the recent surge in business credit has further to run and we believe total credit will continue to outstrip growth in nominal GDP by a wide margin in coming years.

Research can also be viewed on our website:
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