Figure 2.2. First- and Second-Round Effects of the Buildup of Household Debt on Financial Stability

## 1. Balance Sheet View 2. Cash Flow View **Household Sector Household Sector** Assets Liabilities Income Expense **Debt** Mortgages Housing Consumption Labor income Financial assets Capital income Debt service Consumer credit Other assets Other expenses Other liabilities Human capital Worsened household balance Fisher's debt-Declines in A Households cut back High debt High debt consumption further sheets lead to more deflation: declines household level level defaults, bankruptcies in asset prices income due to lower income Housing/ Debt Corporate Debt securities default/ investment and overhang market bankruptcy employment Bank capitalization Declines in corporate Downward price Deleveraging spirals due to is impaired, banks investment and private reduces aggregate collateral constraints reduce lending employment demand Financial sector Real economy Initial effect after a negative shock hits highly indebted Initial effect after a negative shock hits highly indebted households (for example, income shock, credit tightening) households (for example, income shock, credit tightening) Second-round effects Second-round effects

## Source: IMF staff.

Note: This figure depicts the interactions between household debt, the financial sector, and the real economy. The balance sheet view (panel 1) shows assets and liabilities (debt) at the household level, whereas the cash flow view (panel 2) shows household income and expenses in the form of consumption and debt service. The two main channels through which household debt and consumption interact are deleveraging and debt overhang. Debt overhang may adversely affect aggregate demand through deleveraging or a crowding out of consumption by the debt service burden. Deleveraging can occur through forced or accelerated repayment of debt, reduction in new credit, and increased defaults or personal bankruptcies. From a legal standpoint, default follows from a situation in which assets and income are insufficient to cover debt-servicing costs, and bankruptcy from lack of sufficient assets and income to repay the debt. There may be second-round effects, such as Fisher-type debt-deflation dynamics, that may be caused by downward asset price spirals.