CHAPTER 2

HOUSEHOLD DEBT AND FINANCIAL STABILITY

Summary

Although finance is generally believed to contribute to long-term economic growth, recent studies have shown that the growth benefits start declining when aggregate leverage is high. At business cycle frequencies, new empirical studies—as well as the recent experience from the global financial crisis—have shown that increases in private sector credit, including household debt, may raise the likelihood of a financial crisis and could lead to lower growth.

Globally, household debt has continued to grow in the past decade. This chapter takes a comprehensive look at the relationship between household debt, growth, and financial stability across a sample of 80 advanced and emerging market economies. Besides aggregate macro-level analysis, the chapter also delves into micro-level data on individual household borrowing to shed additional light on how household indebtedness affects growth and stability at the aggregate level.

The chapter finds that there is a trade-off between the short-term benefits of rising household debt to growth and its medium-term costs to macroeconomic and financial stability. In the short term, an increase in the household debt-to-GDP ratio is typically associated with higher economic growth and lower unemployment, but the effects are reversed in three to five years. Moreover, higher growth in household debt is associated with a greater probability of banking crises. These adverse effects are stronger when household debt is higher and are therefore more pronounced for advanced than for emerging market economies, where household debt and credit market participation are lower.

However, country characteristics and institutions can mitigate the risks associated with rising household debt. Even in countries where household debt is high, the growth-stability trade-off can be significantly mitigated through a combination of sound institutions, regulations, and policies. For example, better financial regulation and supervision, less dependence on external financing, flexible exchange rates, and lower income inequality would attenuate the impact of rising household debt on risks to growth.

Overall, policymakers should carefully balance the benefits and risks of household debt over various time horizons while harnessing the benefits of financial inclusion and development.