PRESS POINTS FOR CHAPTER 3:

DEALING WITH HOUSEHOLD DEBT

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Prepared by Daniel Leigh (team leader), Deniz Igan,
John Simon, and Petia Topalova

Key Points

- **Households in many economies are grappling with elevated debt burdens following the fall in asset prices since the Great Recession. This chapter analyzes the effects of household debt in the aftermath of housing busts and how government policies can reduce the economic costs.**

- **Housing busts and recessions preceded by larger run-ups in household debt tend to be more severe and protracted. The economic weakness reflects the combination of house price declines and the debt overhang resulting from the prebust debt buildup.**

- **Macroeconomic policies, namely monetary easing and fiscal transfers through social safety nets, are crucial in forestalling excessive contractions in economic activity during such busts. However, macroeconomic policies have limits.**

- **Bold and well-designed government policies targeted at reducing the level of household debt and debt service can mitigate the negative effects of household deleveraging on economic activity, at a limited fiscal cost.**

Households in many economies are grappling with the burden of debt accumulated before the Great Recession. During the five years preceding 2007, the ratio of household debt to income rose to historical highs in both advanced and some emerging market economies. The concurrent boom in asset prices—for example, in Iceland, Ireland, Spain, the United Kingdom, and the United States—meant that household debt relative to assets held broadly stable, which masked households' growing exposure to a sharp fall in asset prices. When house prices declined, many households saw their wealth shrink relative to their debt, and, with less income, found it harder to meet mortgage payments. Household defaults, foreclosures, and fire sales are now endemic in a number of economies.

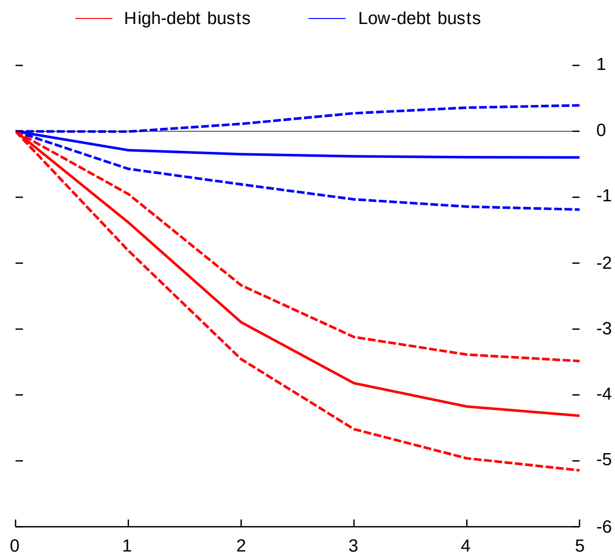
What does this imply for economic performance? Based on an analysis of advanced economies over the past three decades, we find that housing busts and recessions preceded by larger run-ups in household debt tend to be more severe and protracted. Household consumption and real GDP fall more, unemployment rises more, household deleveraging—

paying off debts or defaulting on them—is more pronounced, and the slump persists for at least 5 years. The greater contraction in economic activity in the wake of such busts is too large to reflect only the bigger declines in house prices. And it is not simply driven by the occurrence of banking crises. Rather, it is the combination of house price declines and the prebust run-up in leverage that explains the severity of the contraction. These stylized facts are in line with the predictions of recent theoretical models in which household debt and deleveraging drive deep and prolonged slumps.

What can governments do to support growth when household debt becomes a problem? Our analysis of several historical and current episodes of household deleveraging suggests that macroeconomic policies are a crucial element of forestalling excessive contractions in economic activity during episodes of household deleveraging. For example, government transfer payments to unemployed households through the social safety net can boost their incomes and improve their ability to service debt, as in the case of the Scandinavian economies in the 1990s. Monetary easing can quickly reduce mortgage payments and prevent household defaults, particularly when mortgages have variable interest rates. Support to the financial sector can address the risk that household balance sheet distress affects banks' willingness to lend. However, macroeconomic stimulus has limits. The zero lower bound on nominal interest rates can prevent sufficient rate cuts, and high government debt may constrain the scope for fiscal transfers.

Household Consumption during Housing Busts
(Percent)

The decline in real household spending is deeper during housing busts preceded by a larger run-up in household debt.



Source: IMF staff calculations.
Note: X-axis units are years, where $t = 0$ denotes the year of the housing bust. Dashed lines indicate 1 standard error bands. High- and low-debt busts are defined, respectively, as above and below the median increase in the household debt-to-income ratio during the three years preceding the bust.

Targeted household debt restructuring policies can deliver significant benefits. Bold and comprehensive programs, such as those implemented in the United States in the 1930s and in Iceland today, can significantly reduce the number of household defaults and foreclosures and substantially reduce debt repayment burdens, at a relatively low fiscal cost. In so doing, these programs help prevent self-reinforcing cycles of declining house prices and lower aggregate demand. However, the success of such programs depends on careful design. Overly restrictive eligibility criteria or poorly structured incentives can limit the programs' effectiveness. Overly broad programs, on the other hand, can have serious side effects and undermine the health of the financial sector.