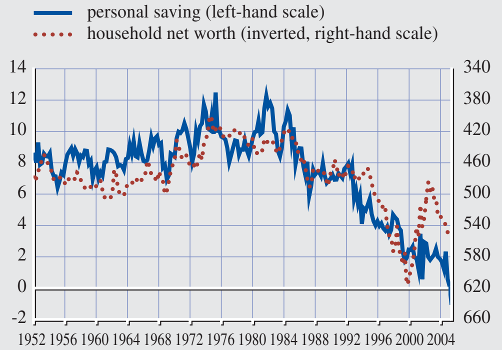
Box 2

FALLING SAVINGS AND RISING DEBT IN THE HOUSEHOLD SECTOR: A FINANCIAL STABILITY RISK?

The personal savings rate in the United States has declined steadily over recent decades and fell to a negative value in the third quarter of 2005 (see Chart B2.1). At the same time, household sector indebtedness has risen to historically unprecedented heights (see Chart B2.2). Somewhat similar patterns have also been observed in other mature economies, such as Australia and Canada. These developments have occurred against a background of rising household sector net worth, an important part of which has been due to valuation gains on wealth holdings. This Box discusses some of the financial stability risks that could arise from an increased dependence on asset valuation along with any associated increase in leverage of household balance sheets.

Chart B2.1 US household saving and net worth

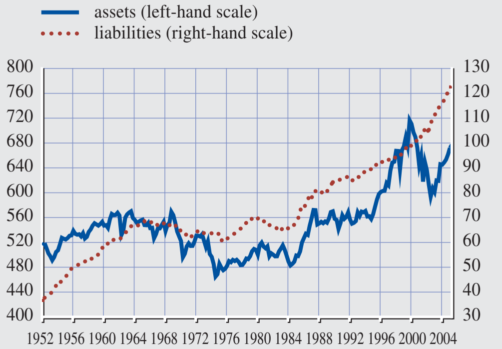
(% of disposable income)



Sources: US Federal Reserve Board and Bureau of Economic Analysis.
Note: Household sector net worth refers to households and non-profit organisations.

Chart B2.2 US household liabilities and assets

(% of disposable income)



Source: US Federal Reserve Board.
Note: Household sector asset and liability holdings refers to households and non-profit organisations and, for liabilities, also incorporates personal trusts.

Rising asset valuations may have contributed to the observed drop in savings through households' decisions related to lifetime wealth building. While the standard measure of the household sector saving rate as reported in the national accounts has fallen considerably over the past decade, it does not take into account changes in the market valuation of existing household assets. Market valuation has been influenced by higher than historical average returns on asset holdings over this period and in this way may have supported households' expectations of continued strong wealth valuation on their financial and non-financial wealth and hence weighed negatively on savings.[1]

Rising valuations on existing household asset holdings may also have favoured the observed strong rise in indebtedness through financial innovation and the associated availability of credit. This factor may be especially important in residential housing markets, whereby a surge

1 In this sense, household wealth building can be broken down into an *active* component (the national accounts notion of the saving ratio) and a *passive* one (capital gains on existing assets). See F. Juster, J. Lupton, J. Smith and F. Stafford (2004), "The Decline in Household Saving and the Wealth Effect", *Federal Reserve Board of Governors Working Paper*, April.

in leverage has occurred owing to an expansion of homeownership – also to households which may have been credit-constrained in the past – along with enhanced access to equity built up in housing. This higher degree of leverage implies an increased sensitivity of household balance sheets to changes in asset prices.

An increased asset dependence and any associated leverage imply financial stability risks through both a direct channel (increasing credit risk for the financial sector) and an indirect channel (spillover effects from the broader macroeconomy). Concerning the direct channel, increased credit risk may arise directly given the risk inherent in leveraged acquisition of assets. In this respect, asset values can vary considerably whilst the nominal value of debt is fixed – and although household debt expansion has been roughly matched by a similar expansion in household assets, household debt has historically displayed significantly less volatility than household assets (see Chart B2.2). Any strains associated with a rapid deterioration in the value of debt collateral could be manifested in increasing default rates in the household sector, including strategic defaults. This could entail potential spillover effects to financial sector balance sheets through their exposures to household sector defaults. Concerning the indirect channel, such a spillover effect could be amplified by a deteriorating macroeconomic environment that places strains on households' ability to repay accumulated debt, possibly due higher unemployment rates or arising from a curtailing of household spending in favour of increased personal saving. In those economies where wealth valuation effects have increasingly been used as a substitute for personal saving in lifetime wealth building, a marked fall in asset values has the potential to trigger a compensatory increase in personal saving – implying a slowdown in household consumption – if households also revise downwards expectations regarding future returns on asset holdings. This in turn could have a significant effect on the economy, given the importance of household consumption in national income, thereby also possibly adding to any strain on financial sector balance sheets.