Economic Bulletin.

8 September 2020

Households hit pause on debt as Covid-19 knocks earnings.

- Households are racking up less debt as their incomes take a severe hit due to Covid-19.
- Although our debt levels are at a record high, low interest rates mean that New Zealanders' debt servicing burden is actually the most manageable it's been in decades. Our debt is also backed by assets and the banking system is in a stronger position than during the GFC.
- We expect interest rates will remain low for an extended period, with the RBNZ likely to cut the cash rate in early 2021. That will help to keep households' debt servicing requirements at low levels.
- Household borrowing is set to increase over the coming years. While Covid-19 has been a significant drag on the housing market in recent months, low mortgage rates are likely to see a sharp reacceleration in both house prices and turnover through 2021, which will boost borrowing.
- Some pick-up in debt over the coming year in response to low interest rates isn't necessarily a problem. In fact, it would indicate that one of the key channels that the Reserve Bank is using to boost demand is working.
- However, if interest rates rise in the future many borrowers could find their debt servicing requirements ratcheting up while house prices fall. High debt levels in that environment would be problematic for New Zealand.

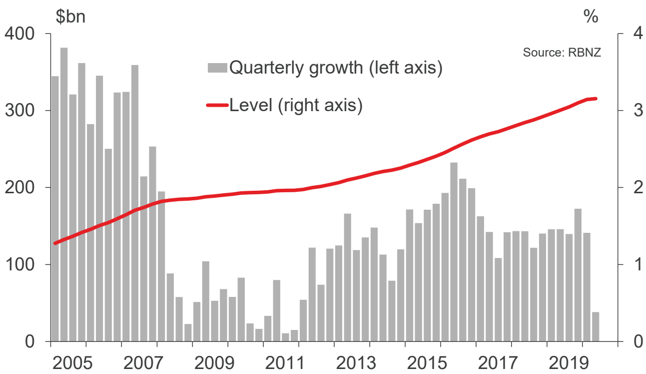
Covid-19 has put the brakes on household debt levels.

Households' financial liabilities (including debt on rental properties) rose by just 0.4% in the three months to June. That's a sharp slowdown from recent years when debt levels have been rising by around 1.6% each quarter.

Contributing to this slowdown in debt accumulation has been the cooling in the housing market. The lockdown of the economy resulted in house sales falling by nearly 40% in the June quarter, with house prices dropping 1% over the same period. Those conditions caused a sharp slowdown in residential mortgage lending.

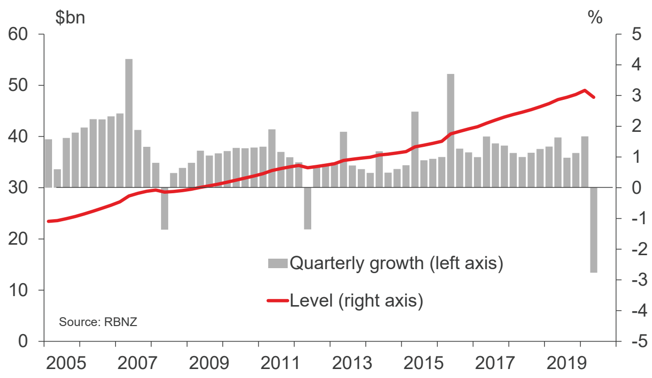
Underlying these trends, however, has been a divergence across different types of household debt. Debt on owner-occupied dwellings and other forms of household debt rose by only 0.2% in the June quarter. In contrast, debt leveraged against rental properties actually rose by 1%.

Households' financial liabilities (including rental properties)



Covid-19 has also been a significant drag on household incomes. Disposable incomes fell 2.7% in the June quarter. That's the first decline in disposable income levels since 2012 and the largest decline in more than two decades. Notably, through this period many households had their earnings propped up by the wage subsidy scheme, which will soon come to an end.

Households' disposable incomes (quarterly)

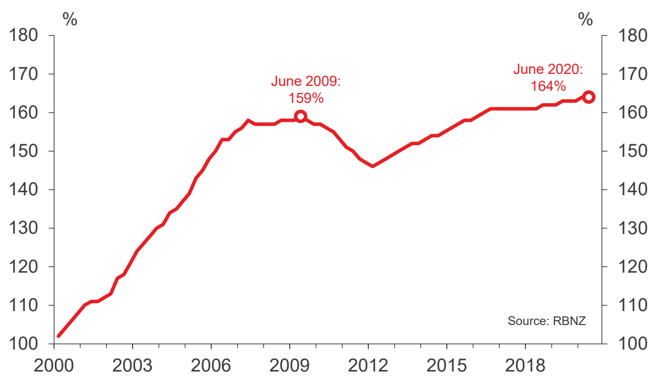


Household debt is at its highest level in more than two decades...

Debt levels have risen rapidly in recent years, far outpacing the growth in incomes. As a result, households are now carrying debt that's equivalent to 164% of their disposable incomes. That's the highest level on record. As a comparison, debt-to-income peaked at 159% during the Global Financial Crisis.

Notably, this increase in debt levels hasn't just been a result of investor borrowing. In fact, while debt on rental properties has risen by 52% since 2012, owner-occupied borrowing and other forms of household debt have risen by 62%.

Household debt as a share of disposable incomes (including rental properties)



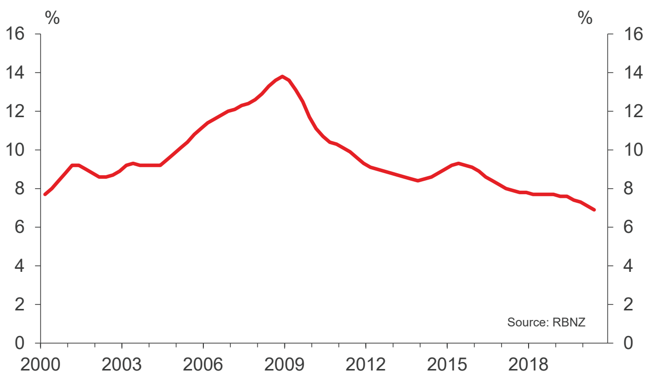
...but that debt burden is looking more manageable than it has in a long time.

New Zealand's high levels of household debt do raise concerns about the economy's longer-term financial stability. In particular, higher debt levels mean that the economy is more vulnerable to unfavourable changes in economic or financial conditions, especially as such disruptions could be amplified through changes in the housing market.

But while our debt levels may be at a record high, they're less worrying than they appear at first blush. In fact, New Zealanders' debt servicing burden is actually the most manageable it's been in decades. Reductions in interest rates mean that the proportion of households' incomes spent on debt servicing has fallen to just 6.9%. That's down from 7.1% at the start of the year, and the lowest level in at least two decades. Debt servicing requirements will also have been limited by relief measures introduced in the wake of Covid-19 that have allowed households to reduce or defer interest payments.

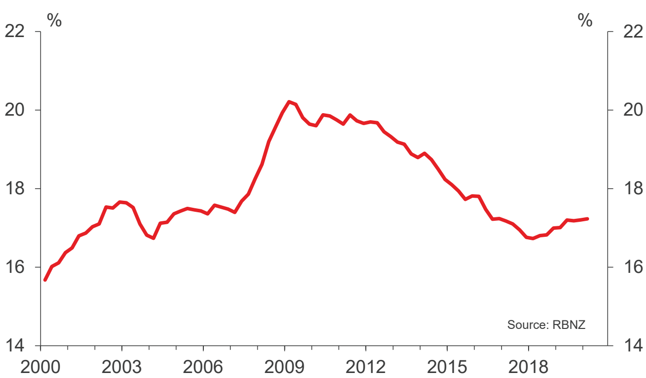
We expect that the RBNZ will cut the Official Cash Rate to -0.50% in April 2021, and that the cash rate will stay low for an extended period. That will help to keep households' debt servicing requirements at low levels.

Debt servicing costs as a share of households' disposable incomes



A further notable feature of the increase in debt levels in recent years is that much of it has been secured against housing assets, including investment housing. Consequently, households' debt levels remain low compared to the size of their asset base (though that figure will have been flattered by the strong growth in house prices in recent years).

Households' debt-to-asset ratios



On top of those conditions, New Zealand hasn't encountered difficulties funding our external liabilities. Our current account deficit is only around 3% of GDP and has been getting smaller in recent years.

Finally, New Zealand's banking system has entered the current downturn in a stronger position that it was in during the 2008/09 financial crisis. Since that time, banks' capital ratios have increased, and their liquidity positions have improved. That means New Zealand's financial system is better positioned to weather the current downturn.

While debt is at record levels, the amount households are spending on debt servicing has fallen to its lowest level in more than 20 years.

Debt levels are set to climb...

New Zealand's household debt to income ratio is likely to increase over the year ahead, as incomes soften and debt rises further.

Household incomes are likely to come under further pressure this year. With a dialling up in the Alert Level, economic activity has cooled and job losses have been mounting. We're also likely to see a softening in the jobs market as the wage subsidy programme comes to an end.

The housing market has cooled in the wake of Covid-19. However, with mortgage rates at low levels, the current softness is likely to give way to a period of increased turnover with house prices set to rise by 8% in 2021. And a strengthening housing market usually means more debt. For owner occupiers, low mortgage rates mean debt servicing is now more affordable. Similarly, for investors the combination of low interest rates and the removal of loan-to-value restrictions means that the purchase of rental properties is looking much more attractive than leaving their money in the bank.

...as monetary policy acts to boost demand in the wake of Covid-19.

While our debt levels are high, some further pick-up in response to low interest rates isn't necessarily an immediate problem. In fact, it would indicate that one of the key channels that the Reserve Bank is using to boost demand is working as expected. When interest rates decline, households have more of an incentive to spend and take on debt, and less incentive to pay it back. And with New Zealanders holding the bulk of their wealth in housing assets, the expected pickup in the housing market is also likely to support a rise in household spending.

However, over a longer timeframe New Zealanders' high debt levels could prove problematic. Although we expect interest rates to remain low for an extended period, in the future we expect interest rates will rise again. When they do, many borrowers will find their debt servicing requirements ratcheting up, and for highly indebted borrowers such increases could be marked.

Simultaneously, higher interest rates would make housing assets look a lot less attractive. This would put downward pressure on prices and could see debt-to-asset positions deteriorating. In such circumstances, many borrowers would find their borrowing ability curtailed, while debt servicing requirements result in their disposable incomes being squeezed – a combination of conditions that would drag spending levels down.

The resulting combination of falling asset prices, constrained consumer spending and possibly debt defaults is a long-term threat to the stability of the New Zealand economy.

Continued low interest rates will boost house prices and debt levels over the coming months. That's a sign that monetary policy is working, but it poses long-run threats.

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