

Seong-Tae Lee: Household debt – implications for monetary policy and financial stability

Opening address by Mr Seong-Tae Lee, Governor and Chairman of the Bank of Korea, at the Bank of Korea/Bank for International Settlements Seminar, Bank of Korea, Seoul, 28 March 2008.

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Opening remarks

Ladies and gentlemen,

I bid a sincere welcome to central bankers participating in this seminar held jointly by the BIS and the Bank of Korea. Let me also express my deep gratitude to our keynote speaker, Dr. Eric Rosengren, president of the Federal Reserve Bank of Boston.

This seminar, a part of the Asian Research Programme of the BIS, is held to allow the exchange of each central bank's experience and opinions concerning major monetary policy issues.

The theme of this seminar, "Household Debt: Implications for Monetary Policy and Financial Stability", should be of great interest to us all. It is very closely related to the current international financial market turmoil generated by the US sub-prime mortgage meltdown.

Background to the increase of household debt

As you are all well aware, household debt in many countries has increased quite sharply since the early 2000's.

In the US, the ratio of household debt to GDP rose from 75% in 2000 to 104% in 2007. This was led largely by an expansion in mortgage lending.

According to an analysis by the IMF, household debt in some 12 Asian countries including Korea, Japan and China grew by an average 15% per year between 2002 and 2006. About two-thirds of this growth consisted of increased mortgage debt.

The reasons for this rapid buildup of household debt are to be found to a certain extent in demographic changes. The aging of the baby boom generation, together with urbanization, fueled a steady increase in housing demand. To my mind, however, an even greater factor behind the increased household debt was the continuation of low inflation and low interest rates.

Over the last few years, heightened productivity based on the IT revolution and the progress of globalization served to keep prices more stable. In line with this, central banks in every country maintained their policy rates at low levels. This resulted in low lending rates, which subsequently led to even greater demand for household loans.

As anticipations of real estate price increases formed owing to the abundant global liquidity, mortgage lending for the purpose of speculative housing purchases also expanded sharply.

In the US and other advanced countries, moreover, mortgage securitization and the transfer of credit risk were made easier thanks to the development of advanced financial techniques. This acted as an additional factor boosting household debt.

Assessment of the increase in household debt

This great increase in household debt did bring positive effects to the macro economy, as well as household welfare and financial institutions business.

The expanded borrowing opportunities of households helped to improve their qualities of life, by making life-cycle consumption-smoothing and house purchases easier.

Financial institutions were able to enjoy a wider range of profit opportunities, through household lending and through transactions in credit derivatives with household loans as the underlying assets.

The total outstanding volume of credit derivatives worldwide is estimated to have swollen more than 110 times from 180 billion US dollars in 1997 to 20 trillion US dollars in 2006.

In Korea, the share of household lending in banks' total loans rose from 28% in 1996 to 50% in 2006. With corporate demand for funds greatly blunted after the 1997 financial crisis, Korean banks instead increased their profit bases through household lending.

This increased household lending helped to heighten housing market vitality, to stimulate consumption and to enhance banks' profitability. In these respects, it is evaluated as having contributed to the improvement of the macro economy in terms of the trends of business activities and of employment.

Having said this, however, I should point out that if household debt rises to an excessive level, there is a greater likelihood of households being unable to repay the principal and interest on their loans when interest rates rise or housing prices fall.

This, of course, generates financial institution insolvency and financial market turmoil, which in turn has a negative impact on the real economy. This possibility has been dramatically demonstrated by the US sub-prime mortgage meltdown.

In the case of the sub-prime mortgages, strict screening of borrowers' redemption capacities was often neglected at the time of loan extension. Credit risk was then passed through to the financial system as a whole by way of MBSs and CDOs.

For these reasons, when economic conditions weakened, it aggravated the seriousness of the problems of non-performing mortgages with corresponding severe impact on the financial market.

In case of Korea, however, there has been no signs of household debt turning sour so far, although it has increased very rapidly since the early 2000's. The delinquency rates on banks' household loans stood at only 0.6% at year-end 2007.

Future policy tasks

In many countries, a large proportion of household debt is made up of housing finance loans. To maintain household debt soundness, therefore, the absolutely crucial thing is to avoid a housing boom and bust cycle.

To ensure this, policy initiatives are naturally required from the micro angle targeting the supply and demand of housing and the tax regime. An even more important task, however, is to carry out macro economic policies that keep the overall economy on a stable course.

What is more, given that financial innovation can amplify financial unrest, central banks and financial supervisory authorities should redouble their efforts to construct effective systems for monitoring and supervision of financial derivatives.

Closing remarks

Ladies and gentlemen,

I expect this seminar will be a forum for a policy debate, involving in-depth and constructive discussions about household debt issues.

In closing I should once more like to voice my deep thanks to all of you taking part. Although you have a crowded and hectic schedule, I hope you will be able to spare some time to gain a taste for Korean culture and the beauty of spring here.

Thank you.