Household Debt Challenge

Why in news?

According to the RBI, household debt surged to 5.8% of the GDP in 2023, marking the second-highest annual increase since Independence.

What is Household debt?

- Household debt is defined as *all liabilities of households* (including non-profit institutions serving households) that require payments of interest or principal by households to the creditors at a fixed dates in the future.
- In India, it comprises of *consumer durables, house loans and personal loans for education, medical etc.,*

Status of Household Debt in India
• In terms of stock of financial liabilities, household debt remained elevated at *37.6% of GDP in FY23*, as against 36.9% in FY22. • Banking system accounts for more than four-fifths of household debt in India • Housing finance companies (HFCs) and other non-banking finance companies (NBFCs) account for approximately 10 % each • Estimates suggest that the Debt Service ratio (DSR) of Indian households was approximately *12%* in FY23.

How to assess the debt sustainability?

- **Debt service ratio (DSR)-** It measures the *proportion of the household disposable income required to meet debt obligations.*
- This ratio provides insights into the ability of the household sector to service current and future debt obligations given their level of disposable income.
- A *lower DSR* indicates *better sustainability* and a more manageable level of household debt.
- **Factors affecting DSR**- Debt-to-income ratio, residual maturity/tenure, and effective interest rate.

Debt to Income Ratio

- It compares a borrowers' total montly debt payments to their total montly income. It is used to assess a borrower's creditworthiness.
- Debt to Income Ratio=$\frac{Total\ Monthly\ Debt}{Gross\ Montly\ Income}$

Residential maturity

- It is the tenure on which the installment loan must be paid by the borrower in full.

Effective Interest Rate

- It is the rate on which the actual return on investment and rate of interest on loan is calcualated, considering compounding over a period. It offers the exact estimate of the amount the borrowers are laible to pay as interest.
- Effective Interest Rate= $(1 + i/n)^n - 1$. Here i is the annual interest rate and n is the number of compounding periods per year.

How does India's household debt affect Indian economy?

> *At the current pace of growth in debt and income, Indian households would reach the threshold level over the next 5 to 6 years.*

- **Lack of data**- The Bank of International Settlements (BIS) publishes quarterly data on household DSR for 17 advanced economies, but not on any developing country including India.
- **International scenario**- Indian household DSR is similar to that of heavily indebted Nordic countries and it is more than China, France, UK, USA, all which have household leverage of more than 100%.
- **Short term impact**- An increase in household debt can boost economic growth and employment, as households borrow more to spend on consumption and investment.
- This can stimulate aggregate demand and output in the economy.
- **Long term impact**- It can have negative effects on the economy as households may face difficulties in repaying their debts, especially if interest rates rise or income falls.
- This can reduce their consumption and savings, and *increase their financial stress* and *default risk.*
- **External shocks**- High level of household debt make the economy vulnerable to external shocks, such as changes in *global financial conditions*, *exchange rates*, or commodity prices.
- **Increase inequality**- If a household debt is concentrated among low-income or informal sector workers, who have less access to formal credit and social protection, they may bear a disproportionate burden of debt repayment and financial distress.

How to reduce the debt burden of household?

- **Increase residual maturity profile**- Increasing the residual maturity profile of borrowers by 6 months can push the threshold of household leverage by more than 4% points of income.
- **Reduce effective interest rate-** A reduction in the effective interest rate raises the sustainable level of household debt.

What lies ahead?

- Providing adequate relief and support to households affected by the pandemic, such as moratoriums, restructuring, waivers, subsidies, etc.
- Enhancing *financial literacy* and awareness among households about the benefits and risks of borrowing and saving.
- Promoting *financial inclusion* and access to formal credit for low-income and informal sector households.
- Encouraging *responsible lending and borrowing practices* among lenders and borrowers, such as prudential norms, credit ratings, transparency, etc.
- Maintaining *macroeconomic stability* and growth by pursuing sound fiscal and monetary policies.

References

1. Indian Express- India's household debt challenge
2. WEF- Household sector affects economic growth