

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

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 calculated, considering compounding over a period. It offers the exact estimate of the amount the borrower is liable 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](#)

