Non-technical summary for 'The Rise in Household Liquidity'

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It is well documented that household wealth has risen significantly in recent decades and that both sides of the household balance sheet – assets and liabilities – have expanded. We document a less well known phenomenon: household liquid assets (such as cash, deposits and equities) have also risen strongly relative to income over the same period.

When debt is measured after deducting liquid assets, the trend rise in the household debt-to-income ratio in Australia has been much less significant and, in fact, has been falling since the global financial crisis. In other words, households have larger liquidity buffers today than in the past, which can help to service the higher debt.

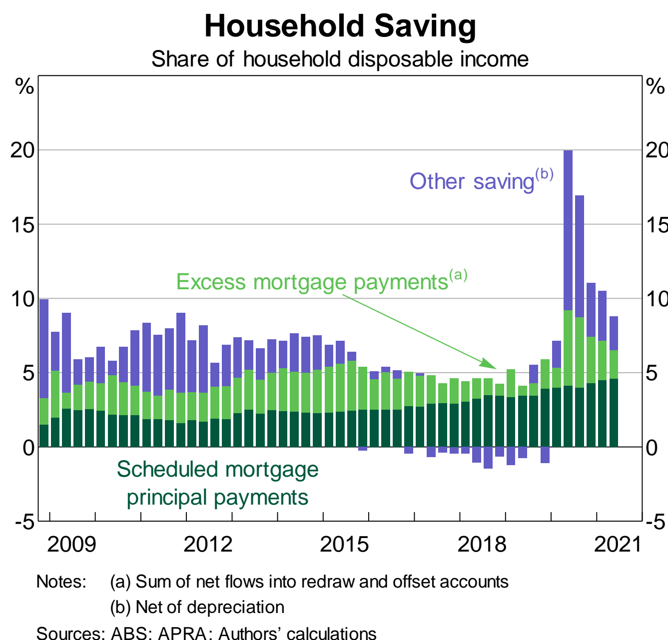
We seek to understand why household liquidity has risen over recent decades by analysing a range of data sources, including the national accounts and various household surveys.

What do we learn?

We find that household liquidity is strongly associated with life-cycle factors, such as age and housing tenure. The increase in liquidity over recent decades has been broad based across households, though strongest among those with mortgage debt. Consistent with this, the share of liquidity-constrained households has declined significantly.

We document that the rise in household liquidity is closely connected to developments in the housing market through several channels. For example, higher housing prices have encouraged potential home buyers to accumulate more liquid assets in the process of saving for a deposit. Higher mortgage debt has also increased the repayment risks associated with future income declines and led indebted home owners to build liquidity buffers for precautionary reasons.

The close link between the rise in household liquidity and debt is well demonstrated by the trend increase in the household saving rate over recent decades, which is mostly accounted for by households devoting a growing share of income to repaying mortgage debt (see the figure).



Our findings demonstrate that the decades-long expansion of household balance sheets does not necessarily mean that households have become overextended. A little recognised 'side effect' of rising housing prices and debt has been the increased rate of housing-related saving through higher mortgage principal payments. This increase in housing-related saving has been supported by the decline in interest rates and has allowed indebted households to build larger liquidity buffers. To the extent that more liquidity is associated with less financial stress, our results suggest that the higher ratio of debt to income has not made the household sector more financially fragile.

What does it mean for policymakers?

To the best of our knowledge, we are the first to document the trend increase in household liquidity and its potential causes. Our empirical findings should therefore help in the development of theoretical models to better understand why households hold liquid assets, and how liquidity is linked to the housing market and the household's life cycle.

Our findings have important policy implications from both a macroeconomic and financial stability perspective. First, the decline in liquidity constraints implies that households may be less sensitive to temporary income and wealth shocks now than in the past. Second, the decline in liquidity constraints, particularly among indebted households, appears to have reduced the repayment risk associated with aggregate mortgage debt over the past couple of decades.