



DIRECTORATE-GENERAL FOR INTERNAL POLICIES

POLICY DEPARTMENT **A**  
ECONOMIC AND SCIENTIFIC POLICY

Financial, Economic and Social Crisis

# Household Indebtedness in the EU

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**DIRECTORATE GENERAL FOR INTERNAL POLICIES**  
**POLICY DEPARTMENT A: ECONOMIC AND SCIENTIFIC**  
**POLICIES**

**FINANCIAL, ECONOMIC AND SOCIAL CRISIS**

# **Household Indebtedness in the EU**

**BRIEFING PAPER**

**Abstract**

This briefing note considers household indebtedness in the EU. It distinguishes the situation in different Member States, noting issues such as the different accounting drivers of indebtedness (e.g. mortgages, consumer credit). It considers the economic drivers of indebtedness and of increased indebtedness during the 2000s, reflecting upon both demand and supply factors (noting how interest rates have evolved in key Member States). It also briefly considers risks arising from high indebtedness.

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## SUMMARY

- **Certain Member States within the EU have become heavily indebted in recent years.** But the pattern is not even. In terms of absolute volumes of debt, France, Germany, Spain and the United Kingdom are the most significant. But relative to the sizes of economies, Cyprus, Denmark, Ireland, Portugal, Spain, and the United Kingdom averaged debt to GDP of some 84 per cent in December 2009 whilst Greece, Italy, Slovakia, and Slovenia averaged just 33 per cent.
- **Mortgage debt is the most important accounting driver of indebtedness.** This constitutes 80 per cent of debt in the high-indebtedness group of Member States, but in contrast, for both the low indebtedness and rising indebtedness Member States, the figure is in the 50s of percent.
- **Demand for debt** can be broken down into consumption smoothing, investment, and unplanned indebtedness. The **supply of debt** is influenced by a number of factors, including the amount and nature of savings; the size and sophistication of the financial services industry; cross-border flows and trade; the degree of economic volatility; currency risk; availability of collateral; institutional factors; and credit market imperfections.
- Certain Member States may have a **higher underlying propensity for indebtedness.** This may reflect factors such as the proportion of consumption devoted to consumer durables, especially housing (e.g. Spain, the UK); the degree of development of the financial services industry (e.g. the UK); a tradition of strong creditor rights, bankruptcy laws and judicial efficiency (e.g. the UK, in contrast to, say, Italy); rapid growth (e.g. Ireland, Spain); demographic changes.
- **In the 2000s, there were a number of particular factors encouraging increased indebtedness.** These included introduction of the euro (reducing interest rates especially in Ireland and Spain); financial liberalisation and development of the Single Market in Financial Services (affecting many Member States, especially through the Financial Services Action Plan); rises in asset prices, particularly house prices (especially in Ireland, Spain and the UK); convergence (particularly for post-Accession Member States); other factors encouraging low interest rates at the global level (such as the rise of China); expectations of future growth and reduced risks of unemployment.
- There are a number of **risks associated with high household indebtedness**, including vulnerability to income shocks; vulnerability to funding and interest rate shocks; deflation, changes in asset prices, and changes in exchange rates.
- We raise a number of **issues for consideration**, including the risk of deflation affecting some Member States (particularly those with high levels of indebtedness to income) more than others; the potential value of counter-cyclical capital buffers; the risk that inflation targeting generates credit cycles and the potential advantages of price path targeting; and various microeconomic measures to address the demand for debt, to encouraging fair competition in debt markets, and to enhance consumer understanding.

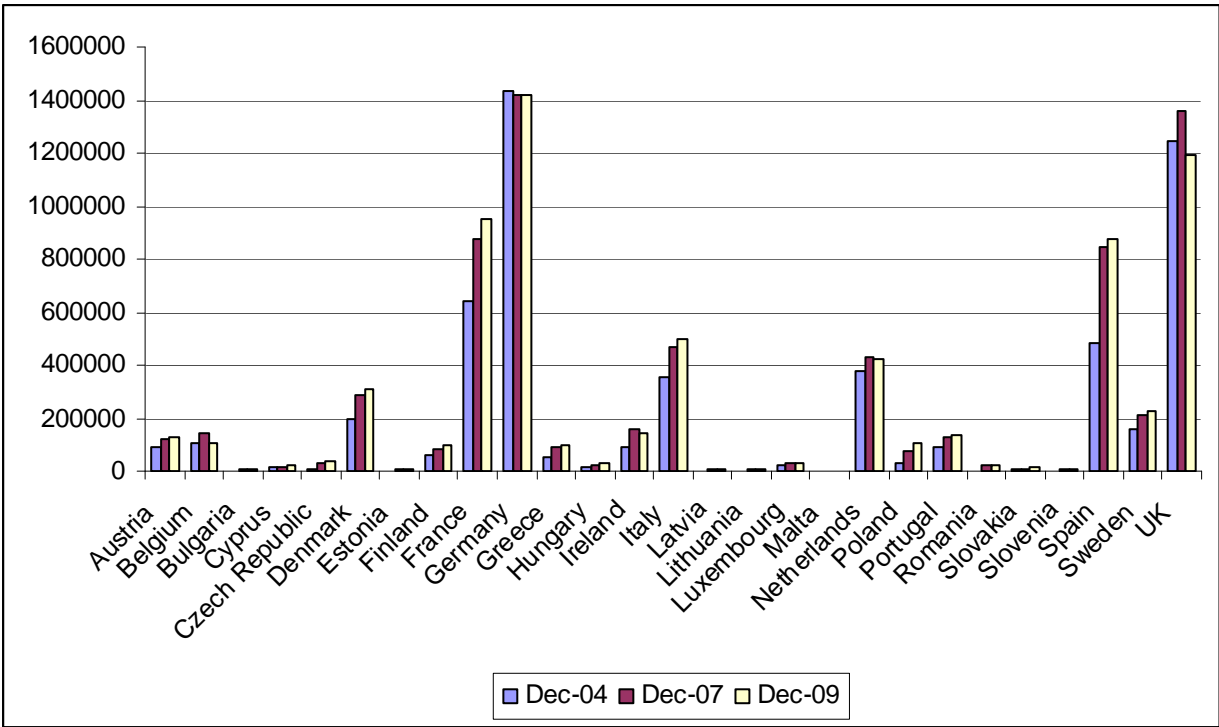
# INTRODUCTION

## 1.1. Degrees of indebtedness in the EU

Many studies have remarked upon the increase in household leverage (both in absolute terms in terms of household income) across much of the developed world during the 2000s. This was not, however, a uniform experience, and in particular was not true in significant parts of the European Union. Indeed, the timing, the extent and the rate of increase has differed markedly across Member States.

There are, however, a number of different ways to measure household indebtedness across the EU. Fortunately they produce broadly the same result. Figure 1 illustrates the changes in the level of household debt across all EU27 Member States between 2004 and 2009.

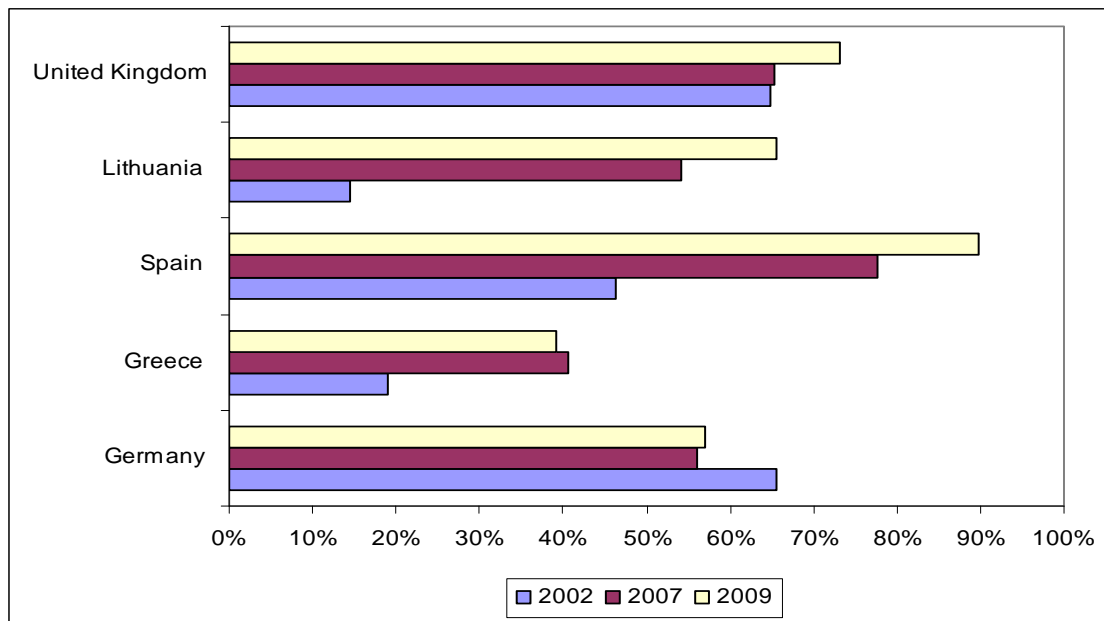
**Figure 1: Total household debt in the EU27 in 2004, 2007 and 2009 (€m)**



Source: ECB, NB: Due the lack of data availability, for December 2004 in the cases of Cyprus (December 2005), Malta (January 2005) and Slovakia (January 2006) the nearest available month for which data was available was used

When making comparisons about the degree of indebtedness between countries, it is common to use the measure of credit to total disposable income of households. Figure 2 illustrates the differences in the debt to income ratio for a selection of Member States.



**Figure 2: Debt to disposable income in selected Member States in 2002, 2007 and 2009**

Source: ECB, Eurostat

It is useful to distinguish between five broad groups of Member States (MS). See Table 1.

**Table 1: Five categories of Member State**

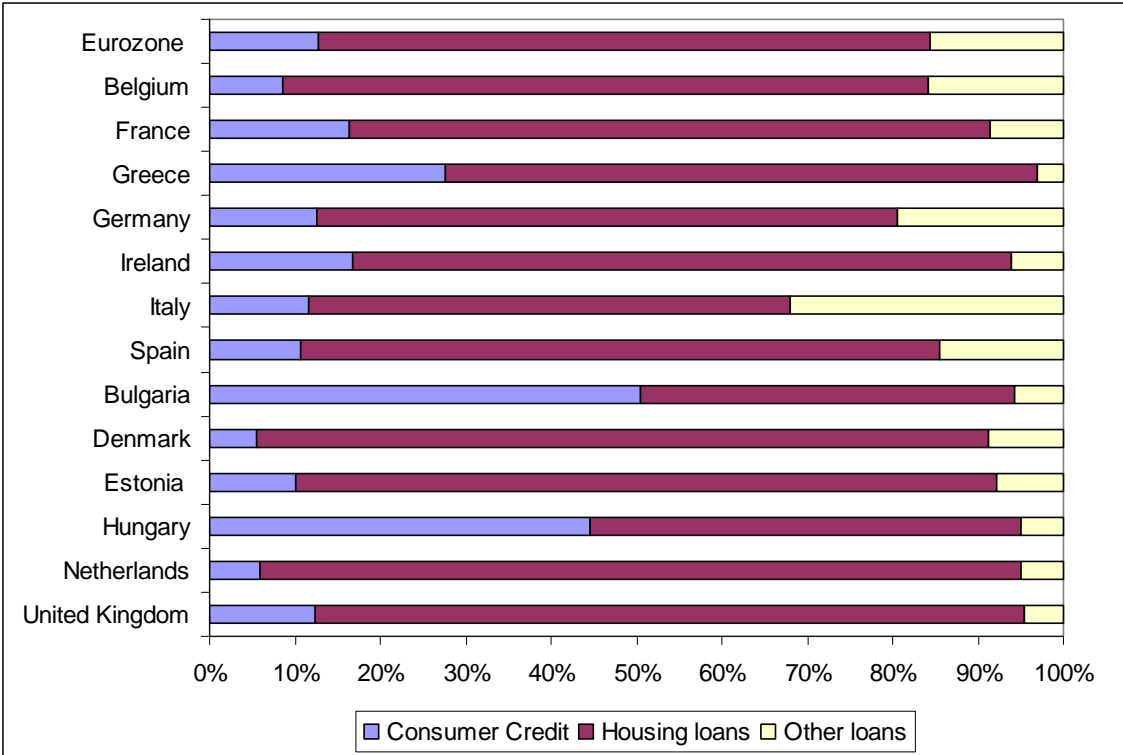
Characteristic	High household indebtedness MS	MS outside the Eurozone where the level of indebtedness is not extraordinarily high, but has risen significantly in recent years	Low household indebtedness MS within the Eurozone – though in all cases involving significant rises in indebtedness in recent years	Falling indebtedness MS, where the level of indebtedness has fallen since 2002	Others – Member States in which indebtedness is relatively moderate and in which changes in indebtedness have not been large in recent years (though in all cases rising)
Member States	Cyprus Denmark Ireland Portugal Spain United Kingdom	Bulgaria Czech Republic Estonia, Hungary, Latvia Lithuania Poland Romania	Greece Italy Slovakia Slovenia	Belgium Germany Luxembourg	Austria Finland France Malta Netherlands Sweden
Average debt to annual GDP (€) (ECB defn)	Dec 09: 84% Dec 07: 76%	Dec 09: 30% Dec 07: 23%	Dec 09: 33% Dec 07: 31%	Dec 09: 56% Dec 07: 57% Dec 02: 63%	Dec 09: 56% Dec 07: 53%

## 2. ACCOUNTING DRIVERS OF INDEBTEDNESS AND CHANGES IN INDEBTEDNESS

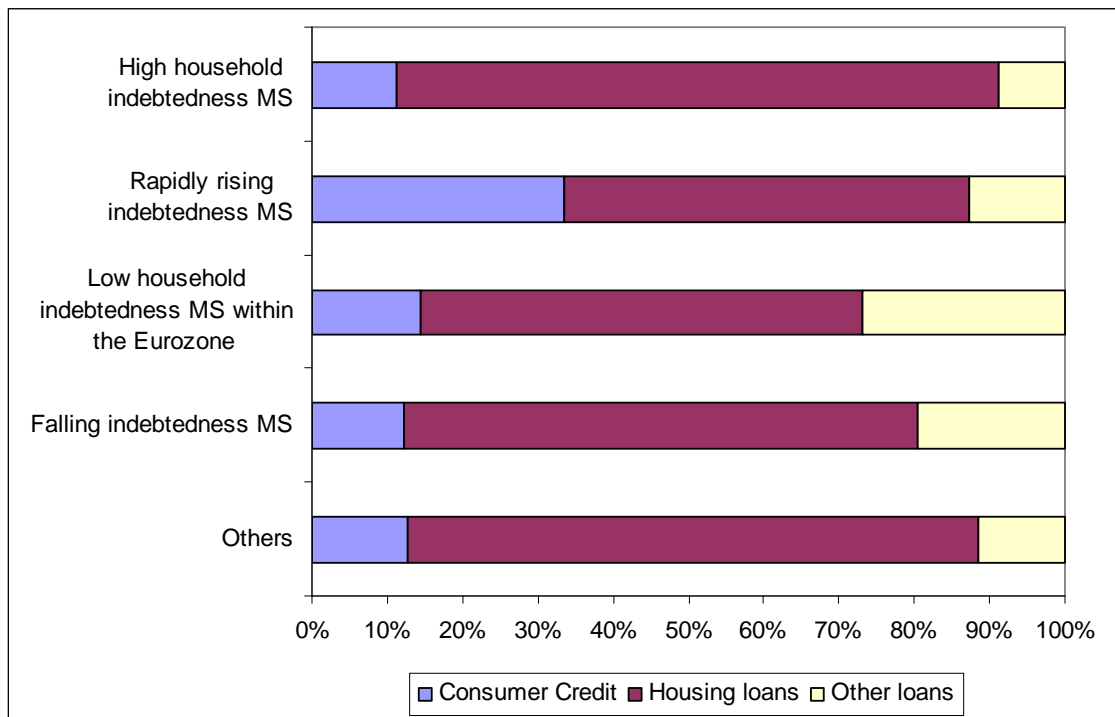
Shortly we shall consider the economic drivers of indebtedness (why people take on debt) and changes in indebtedness (why the amounts of indebtedness in economies might differ and change over time). But first we shall consider the formal breakdown of debt into its various categories – which we refer to as the “accounting drivers”.

Figure 1 and Figure 2 illustrated the composition of household debt, between consumer credit, housing loans and other loans, for a selection of Member States.

**Figure 3: Composition of household debt (December 2009)**



Source: ECB

**Figure 4: Composition of household debt (December 2009) – by category**

Source: ECB

## 2.1. Mortgage debt

The largest accounting driver of indebtedness is mortgage debt as in most Member States it typically represents the largest component in the liabilities side of household balance sheets. Across the EU as a whole this accounts for 67 per cent of debt, in the Eurozone it is 72 per cent, and in the high household indebtedness countries Ireland, Spain and United Kingdom it averages 80 per cent. In contrast, for both the low indebtedness and rising indebtedness Member States, the figure is in the 50s of percent.

There does not, however, appear to be any established linkage between high rates of household ownership and mortgage debt as a proportion of total household liabilities. Southern European countries such as Spain, Italy and Greece for example, have high home ownership rates yet in comparison with countries like the UK, Denmark and the Netherlands (where mortgages are very widespread), far fewer of the households in the Southern European countries own their homes through a mortgage.

## 2.2. Consumer debt

Consumer credit is the second largest component of household liabilities in Europe. Again, the cross-country differences are significant. The most striking feature of the chart is that in the rapidly rising indebtedness Member States the level of consumer debt is much higher — 33 per cent compared with an EU average of just 19 per cent.

### 3. ECONOMICS DRIVERS OF INDEBTEDNESS

#### 3.1. Demand for debt

Households take on most of their debt in a planned way. We can distinguish between two key motivations for such *planned indebtedness*:

1. **Consumption smoothing.** If people never took on debt, then their options would be either to consume all of their income each period or to save up (early in life consuming less than income) and consume from their savings later. In practice, people take some of the latter path in respect of pensions savings. But the life-cycle of earnings typically involves a rising path – i.e. people typically earn less in their 20s (say) than in their 40s and 50s. This is partly because of rising economy-wide productivity over time, but also because people become more productive as they acquire work experience and are promoted and have salary rises because of it.

This means that if they had to save up when they were young, their consumption would differ very markedly between life stages – when young consumption would be much lower than in middle life. And this is certainly true to some extent. But by borrowing when young and paying off debts later, out of raised incomes, people can make their consumption smoother – avoiding unnecessary hardship when young at the expense of modest consumption reductions in mid-life.

2. The second key motivation for planned household indebtedness is **investment**. The most common form of this is **investment in consumer durables**. This concept is most straightforwardly explained using the classic example of house purchase, though other noteworthy examples include cars and household goods. Consumer durables provide a stream of services. If we rented them (e.g. as house tenants) we would pay the cost of those services in the periods we received them. If we buy them, there is an upfront investment. But by taking on debt for such purchases, we better match the period in which we make payments (servicing and repaying our debts) to the period in which we receive the services we purchase. It is certainly possible (and does indeed happen) that finance for housing and other consumer durables proceeds via equity sharing rather than debt (e.g. Islamic mortgages and other shared equity schemes for house purchase). But debt is a much more popular instrument. Another form is **investment in human capital**. A classic example of this might be someone borrowing in order to fund a post-graduate degree. In such a case it is intrinsic to the process that the higher incomes to repay the loan come later than the initial investment.

In addition to planned indebtedness, households also experience *unplanned indebtedness*. This might arise because of unexpected unemployment, illness, or injury reducing labour income by more than it is feasible to reduce consumption in the short term. It might also arise because of unexpected additional costs – such as the unplanned birth of a child. In such circumstances, households take on debt in order to either see them through a temporary shortfall (e.g. if an unemployed worker is expected to find work again soon) or in order to facilitate and smooth the process of reducing consumption to a new lower-and-sustainable level. It is worth noting that if the risk of facing unplanned indebtedness is lower, then households will find it optimal to enter into higher planned indebtedness. This will be important in what follows.

In addition to unplanned indebtedness, households may also fail to plan their level of indebtedness optimally if they suffer from “myopia” (“short-sightedness”). The idea here is that some households may not look far enough into the future to solve their decision problems fully. This could result in them failing to appreciate the full consequences of long-term debts. A related possibility is that households might, through exploitation of problems of asymmetric information or problems in understanding presentations of information (e.g. overly-fixating on minimum monthly credit card payments whilst ignoring the total cost of loans) be induced to over-borrow by lenders or credit intermediaries.

It is important for what follows to understand that the optimal amount of planned indebtedness will depend upon how rapidly income is expected to grow across the lifecycle. If income growth over the lifecycle is more rapid, then it is optimal to take on more debt when younger. Typically, faster-growing economies will be associated with steeper growth across the lifecycle, also.

Further, it is sometimes argued that what may be an optimal level of exposure (in terms of the degree of indebtedness) at the level of the individual household might differ from the optimal level of exposure from the perspective of the economy as a whole. The idea here is that economy-wide, a certain range for the level of savings and consumer spending can be conducive to sustaining growth or maintaining consumer spending per capita. Japan, for instance, is often considered an economy with “too high” a savings rate. More recently, China has also stood out as an economy dependent on spending abroad to mitigate higher savings domestically. The contention is that individuals, for various reasons, including as a result of state policies, may choose a high savings rate which collectively could generate lower than desired consumer demand in the economy, particularly during recessionary times during which precautionary savings may be rise. Household savings behaviour can, subject to other constraints, be offset by public savings behaviour where an alternative economic outcome is desired.

### 3.2. Supply of debt

The amount of household indebtedness can be affected by supply factors as well as demand. In particular, the price and nature of debt might change. We can distinguish a number of issues.

- **The amount and nature of savings.** If savings are higher, then there is more money available to lend, so the price of debt (the most important component of which is the interest rate paid) will tend to be lower.
- **The size and sophistication of the financial services industry.** When the financial services industry is more developed, it can offer savings products that better match demand (increasing savings) and loans that have flexibility or other features that make them more attractive to borrowers.
- **Cross-border flows and trade.** If a country is more open to international capital flows and to cross-border trade, it will make less difference how developed its domestic financial services industry is.
- **The degree of economic volatility.** As well as economic volatility affecting demand for loans (though the impact on unplanned indebtedness) there will also be impacts on willingness to supply. Two key factors here are default risk and inflation risk. If there is more economic volatility, so borrowers are more likely to become unemployed (for example) and driven into default, lenders will be less willing to supply loans at a given

price. Alternatively, if inflation volatility is high, then the real value of loans fixed in nominal terms will be less certain. There may, for example, be a risk that high inflation will mean that the real value of the amount repaid is less than the real value of the amount originally lent. This will again reduce willingness to supply loans.

- **Currency risk.** Cross-border flows and trade, and the degree of economic volatility, might be affected by currency risk.
- **Availability of collateral.** If borrowers have more collateral to offer, then the availability of loans is typically greater.
- **Institutional factors.** Relevant institutional drivers that are likely to affect the supply of credit include:
  - *Ability to enforce collateral claims in the event of default* – If it is difficult to enforce collateral rights in the event of default (e.g. if it is very difficult to foreclose and repossess a house in the event that a mortgage bill is not paid) then the willingness to supply credit will be less. There appears to be extensive evidence that the strength of creditor rights is positively correlated with total lending and that bankruptcy laws and judicial efficiency effect household credit and insolvencies. (The ability to enforce loans of various sorts differs materially across Member States — especially conditions for repossession or foreclosure on housing loans. This is likely to be one significant factor in explaining underlying differences between levels of indebtedness.)
  - *Information sharing among lenders* – this refers to information sharing about the characteristics and the indebtedness of borrowers. The greater the level and detail of information that creditors have about borrowers the more accurately they will be able to predict repayment probabilities. Evidence suggests that breadth of credit markets is positively associated with information sharing. Indeed, studies have found that total lending tends to be larger in those countries where information sharing between lenders is well established and extensive (even after one has controlled for differences between other economic and institution factors affecting bank lending).
- **Credit market imperfections.** Banks and lending institutions may face important limitations in choosing their optimal levels of exposure. Examples of factors that might drive these limitations include:
  - *Asymmetric information* – where banks cannot accurately assess the quality of the borrower (in terms of their riskiness), it may lead to a situation of adverse selection, i.e. where higher risk borrowers are more likely to be selected than low risk borrowers, and the bank finds itself exposed to a greater level of risk.
  - *Misaligned incentive structures* – e.g. where sales staff may have limitations on their incentives to put in adequate effort to sell products or to properly monitor the riskiness of borrowers. A key mechanism for encouraging effort and proper scrutiny is bonus schemes. Where bonus schemes are restricted or discouraged, likely results include a reduction in the volume of credit and a deterioration in the quality of the loan book. On the other hand, when bonus schemes are poorly structured, they can encourage excessive risk-taking.<sup>1</sup>

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<sup>1</sup> The G20 in 2009 endorsed a set of new principles on pay and compensation in the banking sector, stating that compensation arrangements, including bonuses, should properly reflect risk and the timing and composition of

## 4. ECONOMIC DRIVERS OF HIGH OR INCREASING INDEBTEDNESS IN MEMBER STATES

First we should reflect upon why certain Member States might have had an underlying greater household indebtedness even before the 2000s, then move on to consider factors that appear to have contributed to increased indebtedness.

### 4.1. Factors driving relatively high underlying indebtedness

- **Proportion of consumption devoted to consumer durables.** In certain Member States, the amount households devote to investment in consumer durable – in particular to investment in housing – has been relatively high for many years. This is so, for example, in the UK and Spain. If a higher proportion of total consumption goes on consumer durables, then since such consumption is a key driver of demand for planned indebtedness, one would expect the degree of indebtedness to tend to be higher.
- **Degree of development of the financial services industry.** The removal of supply chain constraints has encouraged increases in both the supply and the use of credit across Member States. This has, however, encouraged the build up of excessive leverage. The UK for example, has a longstanding tradition of high development in the financial services industry, and hence would be expected to have higher underlying indebtedness as a result. Despite the sophistication of the UK financial services sector, however, the UK has experienced some of the worst excesses of the recent credit boom and consequently suffered some of the worst symptoms including bank recapitalisations and nationalisations at the tax payers expense.
- **Strong creditor rights, bankruptcy laws and judicial efficiency.** Member States such as the UK with a long tradition of established relatively strong rights for creditors, in particular in respect of house repossession or foreclosure, would have been expected to have relatively higher underlying indebtedness than countries such as Italy in which eviction and thence repossession are very complicated.
- **Rapid growth.** Economies which, even before the 2000s, had experienced rapid growth over an extended period would be expected to have relatively high underlying levels of indebtedness. This was true of Ireland and Spain.
- **Demographic changes.** According to the life-cycle model, countries with higher population growth (and thus a higher proportion of young adults) should have a higher debt to income ratio. Differences in the tax treatment of debt financing might also have an important effect on the demand for credit. Cross-country comparisons on the latter are problematic not only because of the complexity of tax code, but also because of tax legislation differs considerably over time.

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payments should be sensitive to the time horizon of risks. Specifically, payments should not be finalised over short periods where risks are realised over long periods.

#### 4.2. Factors driving rapid growth in underlying indebtedness during the 2000s

- **Introduction of the euro.** In Spain and Ireland, the introduction of the euro produced an immediate large fall in interest rates, reducing the cost of debt and thereby making it optimal to hold more. In addition, the introduction of the euro eliminated cross-border exchange rate risk within the euro area, facilitating cross-border capital flow and cross-border mergers of financial firms. This enhanced the willingness to supply loans, reducing the cost and increasing the sophistication of products offered.
- **Financial liberalisation.** Heavily regulated banking sectors may have been precluding the ability of households to smooth their income across their lifetime, as a result of the various credit constraints that strict financial sector regulation had imposed on households (both directly and indirectly). Thus, a significant component of the growth in household debt might in fact represent a shift from a sub-optimally low level of indebtedness in the period prior to financial regulation to a higher level as households are no longer credit-constrained (at least to the same extent as to the period before financial liberalisation). (It is sometimes suggested that deregulation allowed some institutions to expand their balance sheets and exposure excessively (benefiting from implicit – now explicit – government bailout guarantees), and also allowed others to originate without taking any balance sheet risk themselves (e.g. by selling on the securitised mortgages). These are sometimes proposed as important factors in the recent financial crisis.<sup>2</sup>)
- **Development of the Single Market in Financial Services.** Cross-border capital flows and financial development were also enhanced through the harmonisation of financial services regulation through the Financial Services Action Plan. Though likely to have been a further contributor to low interest rates (and also to more rapid growth – see below) this is likely to have been a less material factor than the interest rate falls associated with the euro. Further, financial integration, when combined with hard currency pegs has led to increases in the proportion of debt denominated in foreign currency through the negative real interest rates. This factor has been particularly relevant in the Baltic States.
- **Rises in asset prices, particularly house prices.** During the 2000s there was an extended house price boom across many countries globally, including a number of EU Member States — notably Ireland, Spain and the UK. As well as raising the volume of debt involved in obtaining new mortgages, house prices growth also allowed established homeowners to release equity from their properties to fund current consumption.
- **Convergence.** Credit growth has been cited as an essential element in the ‘catching up’ process as it is viewed as a key indicator of financial deepening in the household sector in these countries. This is likely to have been a key element in the growth in household debt in the new Member States. Evidence of this might be the high proportion of consumer credit in total indebtedness in Figure 2.

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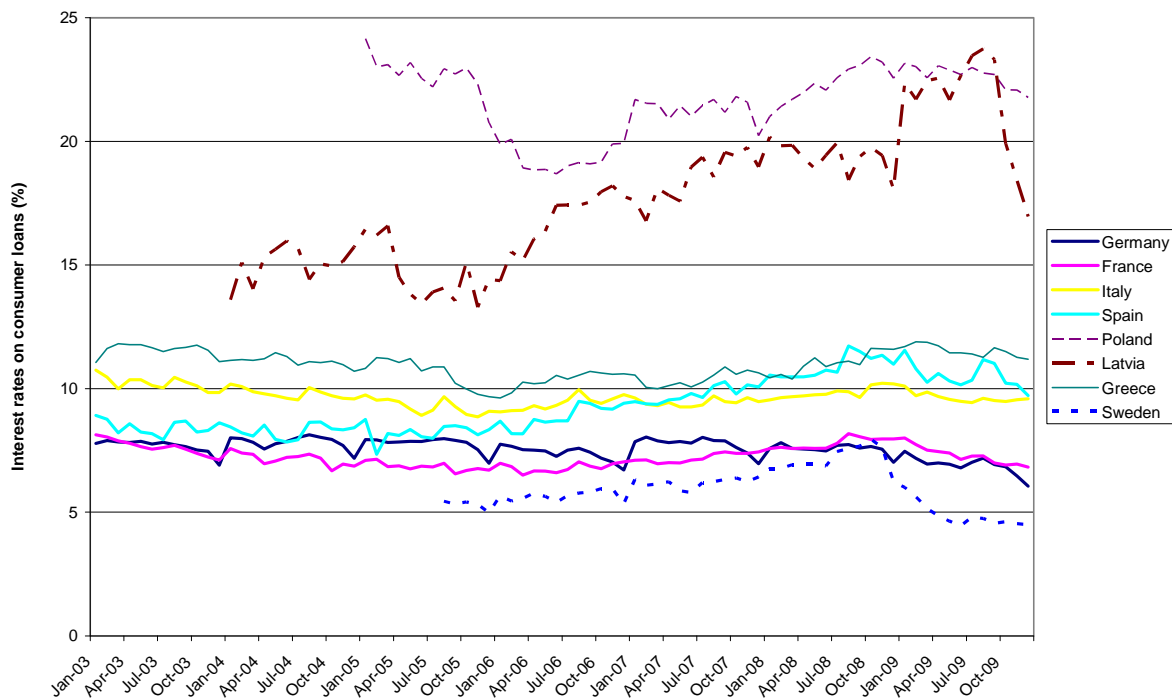
<sup>2</sup> For a fuller analysis of some of the causes of the financial crisis, see for example Annex VII of <http://www.eer.co.uk/download/2009shortAIFMdirective.pdf>



- **Other factors driving rapid growth in financial development.** Particularly in Lithuania and Latvia, the 2000s have seen significant growth in financial development as these post-Communist countries became integrated into the international trading system and the international financial system. This has partly been associated with greater domestic development, but in the Baltic region another factor has been the taking out of mortgages not denominated in domestic currency but instead denominated in euros or Swiss Francs.
- **Other factors driving reduced and consistently low interest rates.** Many other international factors have been identified contributing to historically low levels of global interest rates – including in particular the emergence of China and the development of the internet tending to reduce the prices of certain goods, with the result that monetary authorities focusing upon annual inflation rates responded by reducing interest rates.

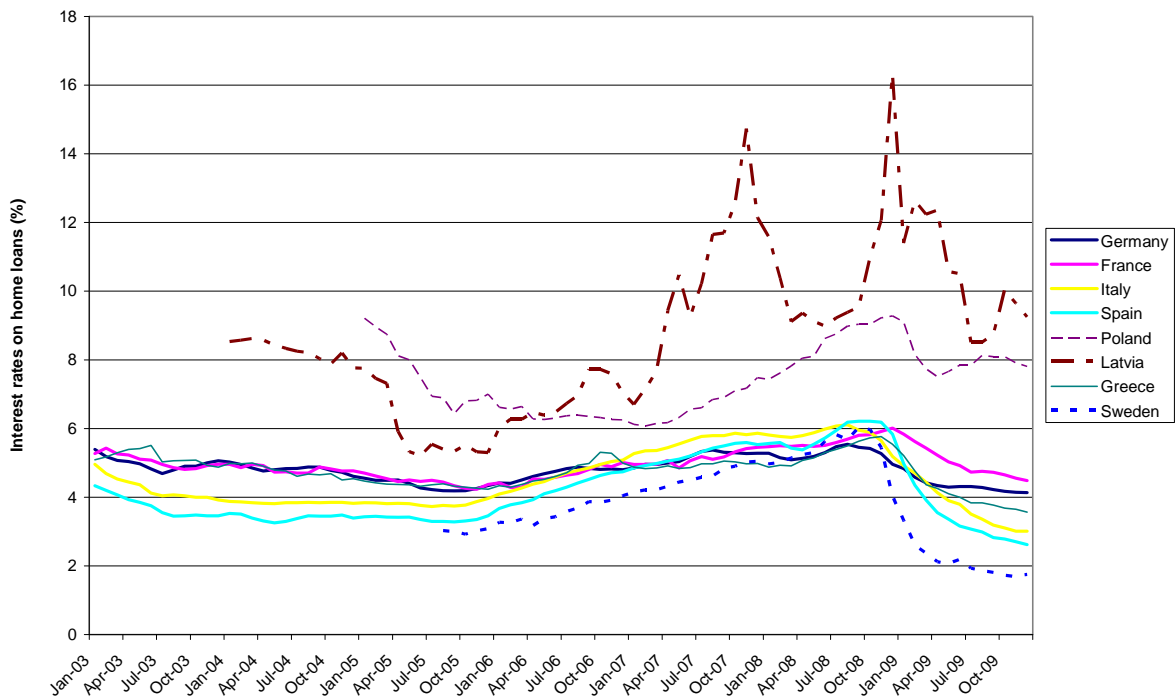
We can see how the various factors above affected the evolution of interest rates for example members of our groups in the following charts.

**Figure 5: Average interest rates on consumer loans (Selected Member States)**



Source: ECB

**Figure 6: Average interest rates on home loans (Selected Member States)**



Source: ECB

- Expectations of more rapid future wage growth.** It is useful to understand the potential significance of this factor through reflecting upon a simple model. Europe Economics has constructed such a model, in which households live and work for precisely forty years and aim to smooth their consumption perfectly, and one twentieth of the population turned over every two years. Under this highly stylized setting, if the expected rate of future wage growth were 3 percent per annum, it would be optimal to hold 1.55 times as much debt as if the expected rate of future wage growth were 2 percent. (By way of reference, on OECD figures UK 2007 indebtedness was 1.58 times its 2000 level.) Larger effects than this may well have been a factor in New Member States.

(It might also be of interest to note that a fall in future wage growth expectations from 3 percent to 2.5 percent would induce a 5 percent contraction in consumption.)

- Reduced risk of future unemployment.** As discussed above, if the risk of unplanned indebtedness falls, the optimal level of planned indebtedness rises.

## 5. RISKS ASSOCIATED WITH HIGH HOUSEHOLD INDEBTEDNESS

In its January 2010 report, *Debt and deleveraging: The global credit bubble and its economic consequences*<sup>3</sup>, the McKinsey Global Institute identifies five factors that it claims indicate that high levels of indebtedness may not be sustainable<sup>4</sup>:

1. **Level of leverage:** For households, this means the debt/income ratio
2. **Growth of leverage:** By this it means the compound average growth rate
3. **Debt service capacity:** This is interpreted in terms of the ratio of debt interest payments to disposable income
4. **Vulnerability to income shocks,** and
5. **Vulnerability to funding and interest rate shocks:** These last two factors ((4) and (5)) are jointly interpreted for households in terms of debt as a percentage of financial assets and the proportion of all mortgages that are variable rate.

On this basis, the McKinsey Global Institute suggests that households in the UK and Spain are highly likely to deleverage significantly in the years ahead.

We dispute McKinsey's interpretation of one of its factors, and would include other factors it does not mention. In particular, we dispute the view that the proportion of all mortgages that are variable rate is a negative for the sustainability of debt.<sup>5</sup> Firstly, we note the higher the proportion of mortgages that is variable rate, the more powerful are rapid central bank interest rate changes as tools of macroeconomic management. When the economy goes into recession, interest rate cuts can rapidly ease outgoings for households with variable rate mortgages – the same is not true of fixed rate mortgages. Second, standard models of the relative impacts of fixed and variable rates on borrowers assume that although inflation varies, the long-term expected rate of inflation is constant.<sup>6</sup> But if there is uncertainty about the long-term rate of inflation, then the use of variable rate mortgages keeps the real interest rate paid more certain.

The significance of this factor is connected to a risk that McKinsey does not highlight: deflation. Falling prices, if sustained and if prices fall by more than productivity growth in the economy, will typically be associated with falling nominal wages. But if nominal wages fall, then the burden of servicing debts becomes greater over time, even with interest rates constant. Given the aggressive deflation in Ireland in 2009 and the risk of further deflation in 2010, we would add Ireland to the UK and Spain on the list of dangerously over-indebted countries.

<sup>3</sup>[http://www.mckinsey.com/mgi/reports/freepass\\_pdfs/debt\\_and\\_deleveraging/debt\\_and\\_deleveraging\\_full\\_report.pdf](http://www.mckinsey.com/mgi/reports/freepass_pdfs/debt_and_deleveraging/debt_and_deleveraging_full_report.pdf)

<sup>4</sup> p. 32ff

<sup>5</sup> It should be noted that the McKinsey view is the standard view, reflected for example in the 2003 Miles Review in the UK – see, for example, *The UK Mortgage Market: Taking a longer-term view*, [http://www.hm-treasury.gov.uk/consult\\_miles\\_index.htm](http://www.hm-treasury.gov.uk/consult_miles_index.htm)

<sup>6</sup> This view is explicitly reflected in the Miles Review. See, for example, p22ff of [http://www.hm-treasury.gov.uk/d/miles\\_review\\_sec12\\_302.pdf](http://www.hm-treasury.gov.uk/d/miles_review_sec12_302.pdf)

Thus the sustainability of household indebtedness will be connected to the risk of sustained wage deflation, and this will be particularly true (and potentially particularly dangerous) in Member States where fixed rate loans are common. Spain, for example, has a tradition of medium-term fixed rate mortgages (of one to five years' duration), and relatively little in the way of longer-term mortgages. In the UK, pure variable rate mortgages are much more common than in Spain. This makes Spanish exposure to deflation more acute, and the ability of households to be supported, quickly, by interest rate cuts more limited.

Two other potentially relevant dimensions of risk might be

- **Changes in asset prices.** Some of the rise in indebtedness, in Member States in which mortgage debt was a significant accounting driver of debt increases, may have been employed to speculate on house prices – either by purchasing a grander main residence than otherwise or by purchasing additional properties for buy-to-let. Lender willingness to support borrowers through difficult periods (unplanned indebtedness) might be related to the level of collateral comfort provided by assets. But there have been significant house price falls in, for example, the UK, Spain and Ireland. This has driven a significant number of households into negative equity. A natural consequence is likely to be that such households are more likely to be driven into default in the event of being unable to obtain unplanned loans. (On the other hand, it is very likely that lenders – particularly banks – currently face very powerful political incentives not to drive creditors into default. This may mean that significant rises in defaults do not occur until after banks become less dependent on state aid.)
- **Changes in exchange rates.** A key differentiating factor between the new and the old Member States is that a material proportion of household loans in a majority of the EU10 are denominated in foreign currency (e.g. to take advantage of lower interest rates and less restricted credit abroad – Swiss Franc-denominated mortgages in Baltic Member States are a well-documented example). This makes them more exposed to the risks of depreciation of their domestic currency.

## 6. POTENTIAL MEASURES AND RECOMMENDATIONS

A number of actions are being taken or considered to address the level of indebtedness across EU Member States and the risks stemming from this. It is useful to distinguish between three categories of such actions:

1. Macroeconomic policy measures
2. Microeconomic preventative measures; and
3. Microeconomic curative measures.

Given the small scale of this report, it has not been feasible for us to investigate all of these options adequately to produce definitive analysis thereof or recommendations beyond those concerning issues to consider.

### 6.1. Macroeconomic policy measures

As a **short-term issue**, heavily-indebted households are particularly exposed to deflation risks. If falling prices lead to falling wages, then the burden of servicing large debts may become overwhelming to the point of inducing largescale defaulting. This could potentially create further problems for the banking sector.

This problem is most relevant in currency areas corresponding with areas of high indebtedness, such as the UK. Average indebtedness across the Eurozone is lower, and so the aggregate ability to tolerate deflation is higher. However, in any currency area the consequences of deflation upon the heavily-indebted tend not to be even across society. The reality is that, even in the UK, there are many households that either have low debts or have large offsetting asset holdings, so that deflation risks are much more muted (indeed, there are likely to be many households for which modest deflation might even be advantageous).

So, although aggregate indebtedness across the Eurozone is lower, the concentration of high indebtedness means that the impacts of deflation may not be so easy to ignore as aggregate statistics might suggest. Sustained relative internal deflation in Ireland and Spain, relative to the rest of the Eurozone, is a necessary mechanism of correction, assisting Ireland and Spain in restoring competitiveness. Ireland was also a well-known recipient of mobile labour during its boom period – a process that may now be partially reversing as an appropriate, natural, and efficient consequence of membership of the common currency area and of the Single Market in general. But if this natural process of relative deflation has, added to it, an overall backdrop of falling prices across the Eurozone, that could increase the burden of adjustment to a level that threatens to result in widespread defaulting. Given the current strains within the Eurozone associated with sovereign debt concerns, it might well be of interest for the CRIS committee to consider in more depth the consequences of deflation for the stability of the Eurozone.

As a **longer-term issue**, the CRIS committee might wish reflect upon the value of macroprudential tools such as counter-cyclical capital buffers to restrain the build-up of debt, for example as per the current consultation on proposed revisions to the Capital Requirements Directive. It might also be of interest to consider the monetary policy framework. It has been argued that frameworks that over-emphasize annual inflation tend automatically to produce credit cycles. There are those that argue that including explicit consideration of asset prices might be an alternative.

A different possibility would be to make explicit consideration of longer-term average inflation (as opposed to the annual rate) – this is sometimes called “price level targeting” or “price path targeting”. Under price path targeting, for example, a “China effect”/“internet effect”-style period of disinflationary or deflationary price pressure might not be responded to by reducing interest rates, even though the short-term consequence would be very low inflation or even slight deflation, because under a price path targeting regime such a temporary negative effect could be “banked” (stored, as it were) in the form of undershooting the path so as to provide scope for inflationary over-shoots later (e.g. as a result of oil price rises of the form experienced in 2007 and 2008). It is arguable that the interest rate cycle produced by the interaction of the China/internet effects with oil prices was an important factor in the debt build-up and subsequent bust. Such interest rates cycles would be moderated by price path targeting.<sup>7</sup>

## 6.2. Microeconomic preventative measures

At the Council of Europe in June 2007 the Committee of Ministers to Member States on legal solutions to debt problems committed themselves to seeking to prevent individuals and families becoming over-indebted by:

1. Collecting information and statistics on debt problems and analysing the situation of over-indebted individuals and families in their countries;
2. Introducing and developing financial literacy on the rights of consumers in general, and budget management in particular, as part of the national education system;
3. Effective access to impartial financial, social and legal advice and counselling to those who have problems with and questions about their debts;
4. Providing the necessary measures and regulations to ensure responsible practices during all phases of the credit relationship including marketing of credit as well as the collection and use of credit data and other financial information; and
5. Safeguarding the rights of the guarantors to information as well as preventing the irresponsible use of guarantees.

Although June 2007 is still less than three years ago, events since then have been dramatic with profound consequences for household indebtedness. There is also much room for interpretation and policy divergence amongst the EU Member States in this package of policies (e.g. what kind of regulatory response best ensures responsible practices during all phases of the credit relationship?) In light of this, some potential further options include:

1. Evaluating the success (or otherwise) of the package of policies agreed by the Council of Europe. The strength of the other policy recommendations made here depends upon the extent of market and regulatory failure or lacunae identified by this evaluation. Policy devised by European institutions, as well as at other policy levels, should seek to be complementary. The outcomes of the Council of Europe commitment to collect information seem particularly important as, in general, there would seem less cause for policy-makers to be concerned by planned indebtedness, as oppose to unplanned indebtedness.

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<sup>7</sup> For more on price path targeting and on why inflation targeting automatically produces credit cycles see Lilico, A., “On the Merits of Price-Level Targeting” in Thomas, H (ed.) *Beyond Inflation Targeting: The New Paradigm for Central Bank Policy*, p10ff [http://www.policyexchange.org.uk/images/publications/pdfs/Beyond\\_Inflation\\_Targeting.pdf](http://www.policyexchange.org.uk/images/publications/pdfs/Beyond_Inflation_Targeting.pdf)

## 2. Policies that address the demand for debt:

- Adequate advice of the kinds proposed by the Council of Europe might limit excessive demands for debt caused by the problems of myopia and exploitation described earlier. It seems likely to be important to provide this advice within contexts in which it is actually taken and understood by consumers.
- The extent of demand for debt depends upon the nature and availability of the supply of debt. While the illegal unregulated loan sector ("loan sharks") are not considered here, those who are financially excluded (i.e. cannot access a bank account) may be pushed towards the illegal unregulated loan sector as a result of a lack of available debt supply from other sources. Consumers may initially be reticent about dealing with such debt providers, but may do so out of lack of supply of other forms of debt and consequently, may find themselves with far higher than optimal stocks of debt.
- Given the relationship, discussed earlier, between indebtedness and prices of consumer durables and houses, broader policy might seek to ensure fair competition in markets for consumer durables and houses to ensure that prices in these markets remain at competitive levels.
- Given the relationship, discussed earlier, between indebtedness and economic volatility, this may be a further justification for macroeconomic policies that seek steady, non-volatile trajectories in GDP growth.

## 3. Policies that address the supply of debt:

- Interest rate caps: The interest charged on debt may be capped to limit the size of debts created by individuals and households. This is done in some, but not all, jurisdictions. The extent to which interest rate caps can be got around by cross border trading in debt within the EU would seem a matter of relevance to policy-making at the EU level. (On the other hand, there is some evidence that imposing interest rate caps (a) drives some borrowers into the illegal unregulated loans sector ("loan sharks"); (b) can deny access to credit for those with impaired credit histories, even though they might be catered for at sufficiently high interest rates. An alternative approach might be to remove all interest rate caps. At higher interest rates, demand for debt might be reduced.)
- Degree of centralisation and co-ordination in credit regimes: Member States vary in these respects, with Germany, for example, operating a highly centralised and co-ordinated regime. The more that this is so the more that we would expect, in general, the supply of debt to be constrained. Again, if the impacts of centralised regimes are being undermined by cross border trading in debt within the EU, this would seem a matter of relevance to policy-making at the EU level.

### 6.3. Microeconomic curative measures

At the Council of Europe in June 2007 the Committee of Ministers to members states on legal solutions to debt problems also committed themselves to taking appropriate measures to alleviate the effects of indebtedness by:

1. Ensuring an efficient and unbiased enforcement system as well as appropriate legislation, which defines the powers of enforcement agents;
2. Respecting the debtor's rights and human dignity at all stages of debt collection and debt enforcement procedures without infringing the rights of creditors;
3. Introducing enforcement alleviation procedures, including the protection of the essential assets of the debtor and garnishment of part of his/her revenue, which take into account the need to strike a balance between the protection of at least the basic living needs of the debtor and his/her family and the efficiency of debt recovery;
4. Ensuring the rights of the guarantors of the debtor at all stages of debt enforcement procedure, including, as far as possible, the right to treatment equal to that accorded to the debtor; and
5. Facilitating the recognition and enforcement in Member States of payment judgments and repayment plans emanating from the competent authorities in other Member States.

As with the preventative policies, the CRIS committee might wish to evaluate the success or otherwise of this policy package. To the extent that this evaluation suggests that further policy intervention seems necessary, the CRIS committee might wish to consider:

- Policies that seek to avoid missing markets: If an indebted household is pushed into bankruptcy due to a lack of appropriate credit supply, there may be a missing market for the provision of this supply. Credit suppliers may be unwilling to take the risk of dealing with indebted households but that is not to say that these households could not bring their debts, over time, to more manageable and sustainable proportions through appropriate credit supply. Markets for the supply of credit to indebted households are complex, and problems over recent years with sub-prime lending have been well documented, but there would be a basis for policy intervention if missing markets of the kind described here can be seen to exist.
- The relationship between curative and preventative policies on indebtedness: There are differences between jurisdictions in approach to bankruptcy resulting from a failure to repay loans. The USA, like the UK, has a liberal regime under which individuals can be discharged from bankruptcy after a relatively short period and re-enter the credit market. Germany and Ireland, for example, have stricter regimes under which individuals remain ineligible for credit for a longer period. The effect of different regimes on types of credit is unclear – there are, for example, considerable differences between Germany and Ireland in the range of credit products they offer – but the overall level of indebtedness is higher in both the USA and the UK. So, while bankruptcy policy forms part of the curative policies, it seems to impact upon future levels of indebtedness, which are addressed by preventative policies.



## 6.4. Author view

In the short timescale and limited scope of this report, we have been unable to cover sufficient territory to provide a robust basis for recommendations concerning the broad and complex issues concerning which were the most material policy failings of the 2000s (if there were any such) and how best to address them. However, a bald statement of our own views may be of interest and so we offer that now.

We believe that the most material issues to consider regarding indebtedness are:

- In the short term, the risks posed by deflation leading to widespread defaulting on debts by heavily indebted households, creating further problems in the financial sector.
- Over the longer term, we would recommend that price path targets be increased in prominence relative to annual inflation targets, thereby creating greater scope to keep interest rates temporarily high during deflationary real cost periods (such as the China and dot-com effects) and therefore face less need to raise rates during temporary real cost spikes (such as the 2007-8 oil and commodity price spike).
- We would also recommend the investigation of counter-cyclical capital buffers, as an additional tool of central bank macroeconomic stabilisation policy.
- We believe that across the EU there remains scope for further deepening of the Single Market and greater competition, and that this should be pursued.
- We also believe that a particularly useful way of enhancing consumer understanding of debt would be to educate households much more that buying a house is investing in a risky asset that can fall in price as well as rise.



DIRECTORATE-GENERAL FOR INTERNAL POLICIES

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