

ECRI COMMENTARY



European Credit Research Institute

Household Debt in Europe's Periphery: The dangers of a prolonged recession

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Double-dip or prolonged recessions have far-reaching consequences on household debt, often distinct from an ordinary brief single-dip recession. Firstly, after the exhaustion of households' asset buffers during the first-dip recession, and when unemployment hits more mortgage-exposed parts of the population, the second-dip recession can trigger a second and potentially more important wave of non-performing loans. Secondly, household debt reduction weighs significantly on the aggregate demand and triggers a vicious debt-deflation cycle, further deepening the recession and preventing households from reducing their debt levels to more sustainable levels. Effective and swift solutions are technically and politically difficult to introduce due to the current institutional and political context, but they are vital in order to achieve sustainable household credit markets in Europe's periphery and beyond.

Against the background of record-high unemployment and decreasing prospects of swift recovery, the focus of financial markets has recently shifted towards the sustainability of European household debt and its potential effect on financial and economic stability. The number of non-performing loans (NPLs) is rising throughout the European periphery and housing loans are slowly but surely following the upward trend. While household deleveraging continues rather successfully in the United States and in other countries of the EU, such as United Kingdom and Denmark, Europe's periphery appears to lag behind in reducing its debt exposure.

This rather objective statement of delayed deleveraging could immediately provoke a commonsensical judgment: Households in some European countries are simply not deleveraging quick enough and their efforts should be increased. In the current context, however, such conclusion is misguided and potentially dangerous. The household debt situation in southern Europe combined with the sluggish recovery presents two distinct dangers, which have to be analysed and dealt with carefully.

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Firstly, there is the danger that the double-dip or a prolonged recession will exhaust asset buffers accumulated during boom times. Unemployment can increasingly hit older population groups with formerly stable employment who are the most exposed to housing loans and who tend to present lower rates of unemployment during short-term crises. If recovery does not come in time to help such households cope with their debt burdens, the second dip of a recession can trigger a potentially more dangerous wave of defaults, which would increasingly concern long-term housing loans rather than just short-term consumer credit. It can further increase the amount of NPLs and have destabilising or even cliff effects on the already-weakened financial sector and ultimately on public finance.

Secondly, in countries where significant government and business deleveraging is occurring simultaneously and where recovery is sluggish or non-existent, as is the case throughout the European periphery, persistent reduction of household debt could become the straw that breaks the camel's back. Household debt deflation has thrown countries into a self-feeding spiral of persistently decreasing aggregate demand, falling consumer confidence, sluggish investment, capital flight, higher deficits, tax hikes and further budget cuts. This vicious circle partly explains the development of the multiplier of fiscal cuts recently revised upwards by the IMF.¹

This commentary argues that time matters in the household deleveraging cycle and that a swift recovery is its vital part. The second-dip recession in Europe's periphery has created a poisonous mix that further threatens the financial system and the economy. Moreover, this paper tries to assess the extent to which these effects may have already materialised and evaluates the risks for countries where they are not yet fully felt. It also offers a theoretical policy response towards a more sustainable household credit sector and overall economic recovery.

Phasing of regular household deleveraging

During brief recessions, banks' short-term consumer-credit assets (including overdrafts and credit card debt) suffer first and most abruptly among household credit products both in terms of defaults (see Figure 1) and volumes (Figure 2).

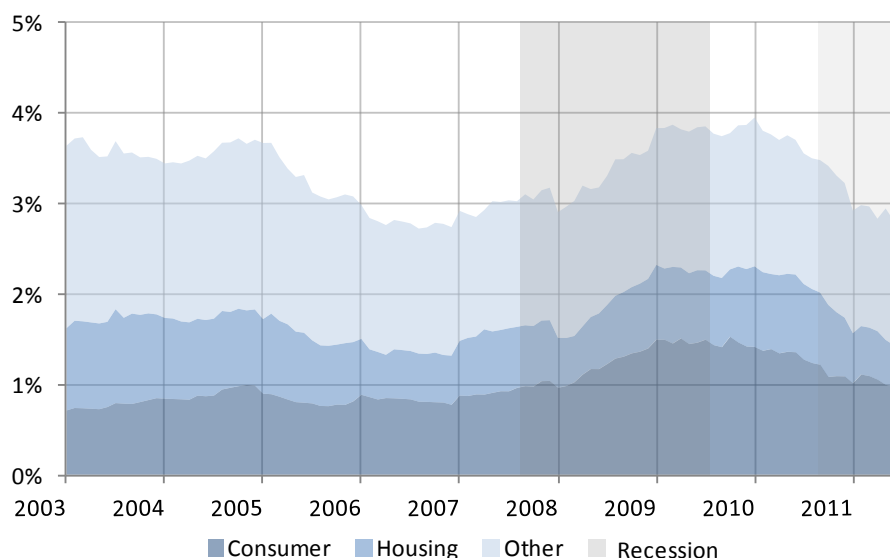
Firstly, in case of unexpected or abrupt loss of income, instalments of consumer loans may become too high relative to income due to short maturities. Even a relatively small overall principal sum of consumer credit can be too difficult to sustain during a recession. Consumer credit is significantly less collateralised than mortgages and, despite a large variance of personal default laws across the EU, a default on a consumer loan is generally easier both to administer and to endure than a foreclosure.²

Secondly, due to the limited principal sum and short maturities, households are generally more prone to fully repay new consumer credit in shorter periods and consequently take less credit to their income, thus adjusting to new perceived sustainable debt levels.

¹ "World economic outlook" (2012), Various Issues, International Monetary Fund, Washington, D.C.

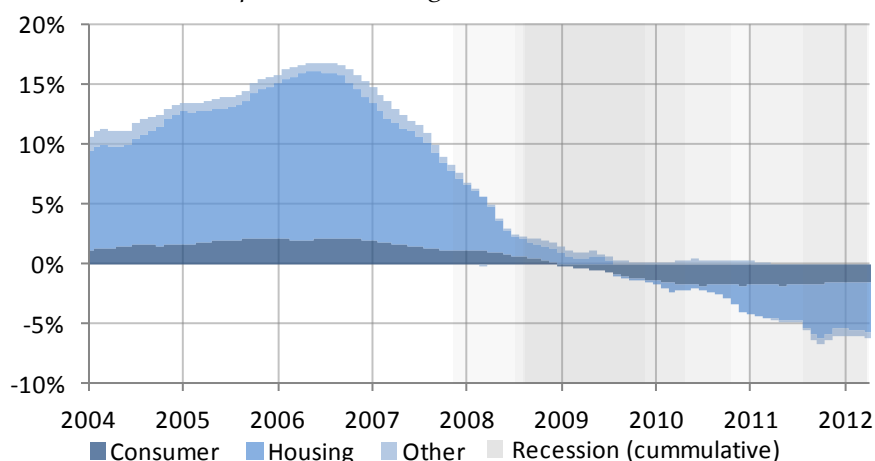
² M. Gerhardt (2009), "Consumer Bankruptcy Regimes and Credit Default in the US and Europe A comparative study", CEPS Working Document No. 318, Centre for European Policy Studies, Brussels, July.

Figure 1. Ratio of 12-month stocks of charge-offs to stocks of all loans to households



Note: The charge-offs constitute a proxy for default rates but are in no way equivalent, since OFIs can adjust their expectations to higher write-offs (explaining relatively low levels in the second dip). Sources: European Central Bank, Eurostat and ECRI.

Figure 2. Annualised moving quarter real growth rates of household debt in Greece, Ireland, Spain and Portugal



Sources: European Central Bank, Eurostat and ECRI.

However, the levels of consumer-credit indebtedness are not unsettling and its flexibility is less prone to provoke large effects on the banking sector as is the case in housing loans. At its peak in 2009, consumer credit represented just above 13% of household debt in the euro area, while housing loans represented 72%. Consumer credit thus corresponds to a mere 7% of bank loans to the non-financial sector.³

Households can also rather easily reduce their demand for consumer credit, since consumption can be postponed without serious repercussions on the standard of living. Asset buffers, such as savings for other purposes, can also be used to bridge a temporary income decrease until the expected recovery kicks in, thereby adjusting household cash

³ Unless stated otherwise, all statistics in this commentary come from the ECRI Statistical Package: Lending to Households, which can be purchased at <http://ecri.eu>.

flows and asset-to-income ratio to revised income expectations. Overall, due to low levels of stock of consumer loans, such a reduction in the consumer credit portfolio has a limited effect on the quality of banks' assets and on the aggregate demand, despite relatively high charge-offs in initial periods of crises.

As illustrated in Figure 2, retrenchment of consumer credit in Europe's periphery during the recent crisis preceded the reduction in housing and other loans. The real amount of housing loans merely stagnated until the end of the Great Recession.⁴ The effective shift of deleveraging to housing loans became predominant during the short recovery and subsequently during the second-dip recession (Figure 2), mainly due to longer maturities and higher sums of principal. Gradually expiring longer maturities enable households to effectively start to transfer their deleveraging efforts from consumer credit to housing loans, contracting for less new loans and thus decreasing debt exposure more significantly than in the initial stage of the crisis.

On an ordinary time-line of household debt cycle, this period of shifting deleveraging towards housing loans is also the moment when recovery arrives and supports households in their efforts, effectively allowing them to partly grow out from their leverage and adjust their indebtedness to newly revised perceived sustainable levels.⁵ Indeed, although deleveraging in the household sector usually starts during a recession, the most significant quantitative part of the debt reduction occurs during the subsequent recovery.

When recovery does not come or does not last, however, adjusting leverage to revised sustainable levels is still expected but becomes less realistic and, more importantly, adds to the downward slope of the economy. Such forced deleveraging weighs heavily on household spending, depresses consumer confidence and aggregate demand, thus reducing medium-term investment and economic output. In this way, households' debt-reduction efforts risk deepening the double-dip and contributing to cyclical unemployment.

Household debt during the second dip

While the second-dip recession could be perceived as a separate story, it has a number of specific attributes, which render an even mild second recession potentially more dangerous with respect to household debt than a severe but distinct single-dip recession.

Firstly, the second-dip recession has serious implications on uncertainty and therefore consumer confidence. During the Great Recession, many households were able to temporarily tighten their belts rather effectively, expecting a rather early recovery and therefore increased income in the medium-term. When the second-dip came to Europe's periphery, these expectations – encouraged by economic forecasts – have been proved

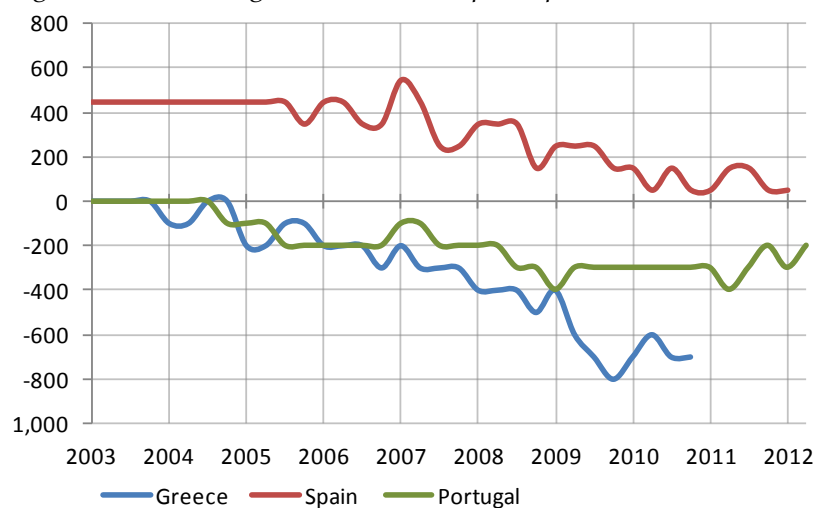
⁴ The term Great Recession refers to the first-dip recession, which occurred in most European countries between 2008 and 2010.

⁵ Depending on the underlying theory, the revised levels of indebtedness perceived as sustainable are either a product of an abrupt reduction in the quantity of debt that a household is able to borrow or it is linked to the liquidity of financial assets in secondary markets. Either way, a reduction in income of the household or of the economy further diminishes the perceived level of sustainable indebtedness. As discussed in more detail below, see G.B. Eggertsson and P. Krugman (2012), "Debt, Deleveraging, and the Liquidity Trap: A Fisher-Minsky-Koo Approach", *Quarterly Journal of Economics*, 127(3), pp. 1469-1513.

wrong. The recovery became ever more distant and uncertain, creating among households and businesses fear of a lost decade or a depression. This explains why consumer confidence is now lower than during the Great Recession and decreasing to historical lows in Greece and Portugal (see Figures 5 and 6).

Secondly, expectations of a short-lived crisis enabled households to bridge their income gap through consuming their asset buffers (see Figure 3), thereby cushioning the welfare repercussions of the first-dip recession. This could partly explain the low ratios of non-performing loans in Spain and to a lesser extent in Portugal. However, if the recession lasts for too long and asset buffers get exhausted, the capacity to deleverage becomes limited. The pace of income reduction can even surpass the pace of debt reduction. Households can reduce their debt burdens, but their ratio of outstanding debt to disposable income, i.e. leverage, and therefore relative cost of the debt burden can rise or stagnate, which has necessarily a knock-on effect on the amount of NPLs.

Figure 3. Net savings (current euros per capita)



Sources: Eurostat and ECRI.

During the recent economic crisis, the return or persistence of the recession in Europe's periphery created an effective gap between the pace of debt reduction and the leverage. This decoupling has been the most flagrant in Greece, where households were effectively decreasing their debt from early 2009 but as shown in Figure 5, their leverage continued to rise until the end of 2011. This phenomenon was less pronounced in Spain (Figure 4), mainly due to the brief recovery in 2011 and much milder second-dip recession. The effect has not significantly surfaced in Ireland, which went through a similar housing bubble as Spain, but maintained growth in times when other countries dipped into a second recession, helping it to offset such effect rather quickly.

In the Greek case, however, the economy was shrinking far quicker than the real stock of household debt, leaving households with unsustainable amounts of debt, triggering extreme and increasing levels of default rates (Figure 7), and amplifying the effects of debt deflation. This decoupling of leverage and real debt occurred roughly a year after the crisis began. More importantly, the rates of non-performing loans have not stalled as was the case in Spain, which registered a short-lived return to growth.

Figure 4. Household debt in Spain

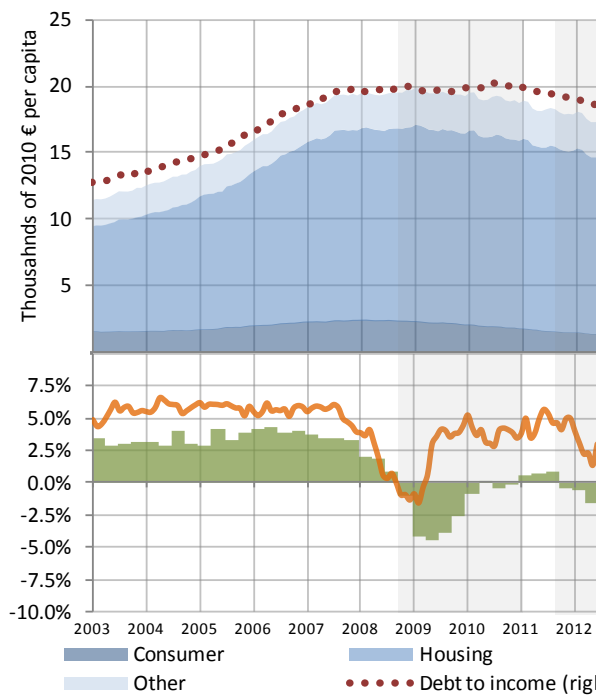


Figure 5. Household debt in Greece

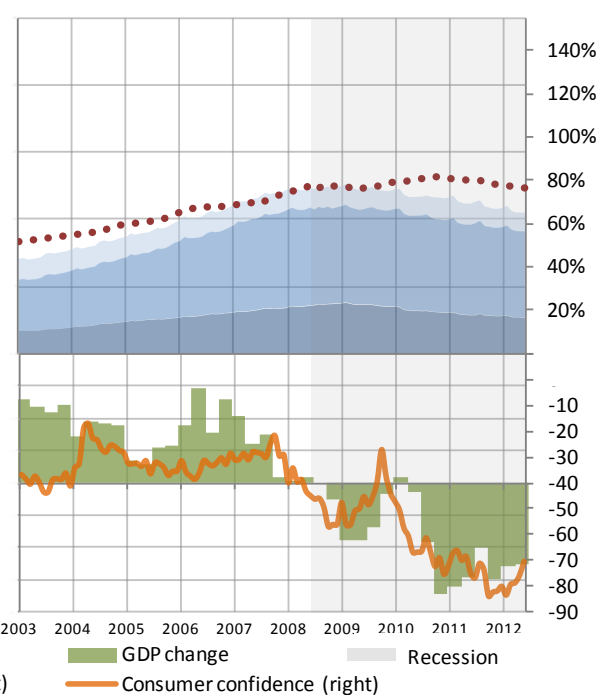
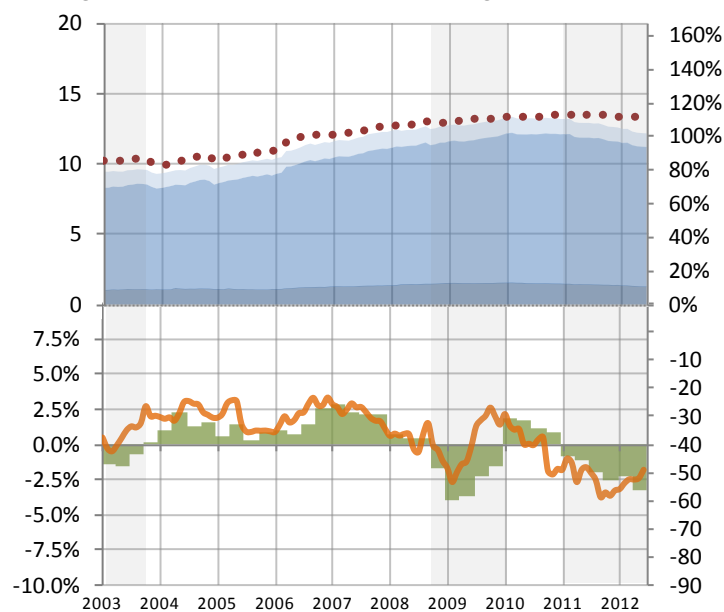


Figure 6. Household debt in Portugal



Note: The graphs have been adjusted so that the value of real debt and disposable income intersect at the start of the recession.

Sources: ECB, Eurostat, ECRI and European Commission.

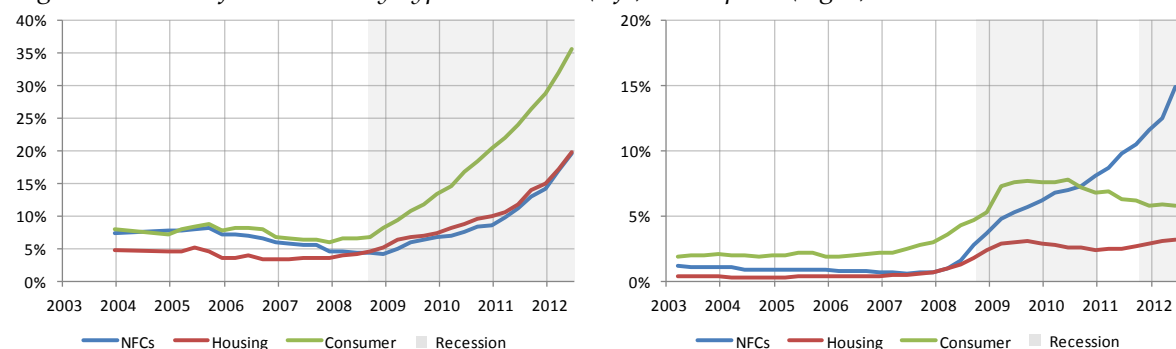
Such a decoupling was not present following the Great Recession in other regions with high household indebtedness, which encountered only a brief or no second-dip recession. Mainly thanks to the increased disposable income during the aftermath of the crisis, households in the United States and the United Kingdom, for instance, have been able to reduce

significantly their leverage to disposable income, while their debt in real terms stagnated or even increased modestly.⁶

The first self-feeding loop: A second wave of non-performing loans

In the context of high unemployment, exhausted asset buffers, grave uncertainty and therefore low expectations of future income increases, this combination of debt reduction and leverage increase has a great impact on the level of non-performing loans. The phenomenon is already observable in Greece but it is only in its initial phase in Spain, where the recovery in 2011 and a milder recession have not allowed it to take full effect.

Figure 7. Ratio of bad loans by type in Greece (left) and Spain (right)



Note: Data for Greece represent NPLs, for Spain 'doubtful loans'. Due to a lack of harmonisation on bad loans by the ECB, definitions may differ and NPLs are not strictly equivalent to bad or doubtful loans. 'NFCs' stands for non-financial corporations.

Sources: Bank of Greece, Bank of Spain and Eurostat.

In this respect, the Greek case should serve as a cautionary example and a lesson for Spain and other countries, whose non-performing household loans could threaten the financial system and public finance. Non-performing loans in Greece account for as much as 21.4% of total loans, while households register delinquency rates of 19.9% on mortgages and an astonishing 35.6% on consumer credit in the second quarter of 2012. This compares with Spain's 9.7%, 3.2% and 5.8%, respectively.⁷

Greek household debt became yet another channel through which the vicious cycle of austerity translates into the broader economy. The drop in economic output caused by investment retrenchment, capital flight and extensive attempts at fiscal consolidation left most of the Greek population with severely-reduced income. This prevented them from servicing fully their debts accumulated during the boom times, often beyond the capacity of their then official income due to the high share of the grey economy.⁸ Countries such as Spain are so far managing to avoid this threat as far as household debt is concerned. However, a similar feed-back loop is already in effect in Spain on other levels, especially in loans taken on by the non-financial sector, which are delinquent in 15% of the cases.

⁶ C. Roxburgh, S. Lund, T. Daruvala and J. Manyika (2012), "Debt and deleveraging: Uneven progress on the path to growth", McKinsey Global Institute, January.

⁷ Numbers for Greece come from individualised compilations by the Bank of Greece. Recent data on Spain's doubtful loans are available at <http://www.bde.es>.

⁸ N. Artavanis, A. Morse and M. Tsoutsoura (2012), "Tax Evasion across Industries: Soft Credit Evidence from Greece", Chicago Booth Research (12).

Greek delinquency rates have registered a surge since the beginning of the recession, while Spain's doubtful loans have risen merely in the early stages of the Great Recession and relatively modestly. However, in recent quarters, the ratio of delinquency rates has been accelerating in both countries, thereby re-enforcing the trend observed in Greece, while in the Spanish case potentially signalling a second wave of delinquencies, similar to the one registered at the beginning of the crisis.

Since the stock of loans of the Greek household sector is virtually identical to the amount of loans to non-financial companies and since the delinquency rates on mortgages are equal to those on business loans, NPL rates of households became a significant part of financial instability in Greece, increasing recapitalisation needs of banks and ultimately the liabilities of the Greek state. The rise in liability occurs despite the fact that the Hellenic Financial Stability Fund, which serves as an intermediary, is a special purpose entity. These flexible-in-size partial bailouts provided by European facilities contributed significantly to the dire state of Greece's public finance and are in part responsible for breaches of the deficit limits set by the memorandum of understanding reached between the troika and the Greek government. Since breaches are usually followed by demands for further spending cuts and tax hikes, household disposable income is additionally decreased, further increasing the delinquency rates, and hence creating a partially self-feeding spiral through the financial system.

Spanish households, on the other hand, have been extremely perseverant both in absolute and relative terms during the crisis and their role in destabilising the financial sector was therefore marginal. This is mainly due to the fact that large parts of the Spanish population inclined to take out housing loans (older and middle-aged couples) have been relatively spared the worst upheavals of the crisis. Their unemployment rates remain lower relative to other population groups and they are less affected by budget cuts than the young or unemployed. Also the fall in the interbank rates played a significant role in keeping the Spanish mortgage market under very low delinquency levels, as the low rates made mortgages both more affordable and easier to sustain (Figure 8). Households in Spain today save as much as 30% of monthly mortgage payments when compared to the initial date when the loan was taken.⁹

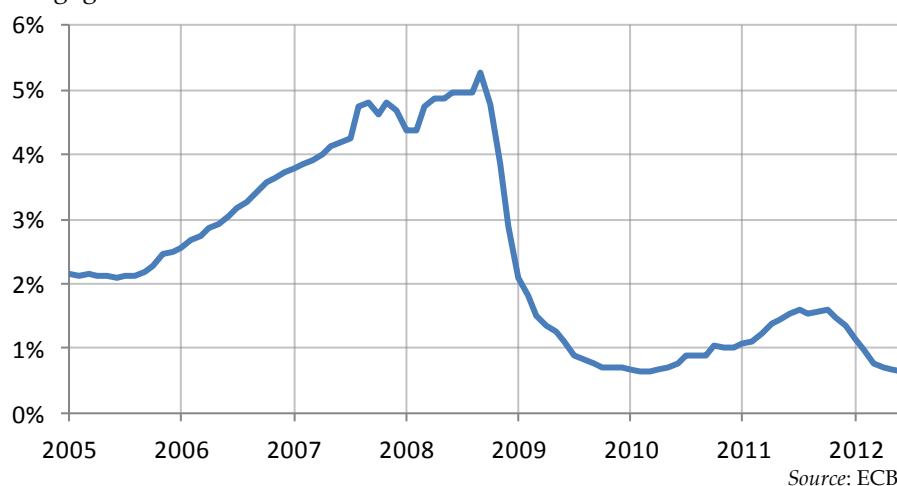
Households still seem to be a rather low threat to Spanish credit institutions, compared to non-financial businesses, with mortgage delinquency rates staying below 3% throughout the crisis until the second quarter of 2012. Doubtful loans to businesses, on the other hand, have been soaring and they represent a major destabilising factor in the financial system.

However, the second recession is starting to be reflected in the bad-loan rates of Spain (see Figure 7). The country could now be facing a significant rise in non-performing mortgages if unemployment of the most mortgage-exposed groups rises, as the trend already suggests (Figure 9). If the economic situation deteriorates further, groups with the highest exposure to mortgage liability would be increasingly threatened by mass unemployment and other major income losses. The perseverance of Spanish households could thus hit a threshold beyond which the credit markets would become a new channel for the crisis multiplier to take effect.

⁹ S. González (2012), "Default on mortgage credit to households", Asociación Hipotecaria Española. Madrid.

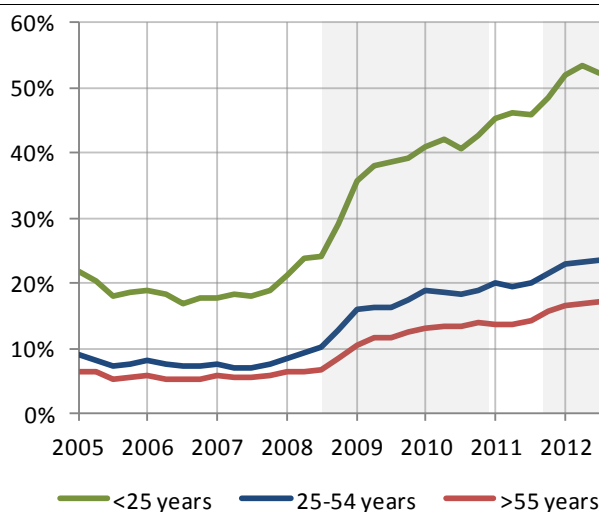
It is difficult to determine the critical threshold, since the freefall of economic output and loan performance in Greece does not give us a clear hint on when exactly the economic problems will spill over uncontrollably to mortgage-exposed parts of population.

Figure 8. Three-month Euribor as a standard reference rate of Spanish mortgages



Since the beginning of the second-dip recession, however, it is becoming clear that no segment of the Spanish population will be spared the slowdown. More importantly, due to structural reforms involving labour-market flexibility, age groups previously under advantageous labour provisions could become threatened by unemployment. If the trend is to continue, the role of the Spanish household debt could change abruptly and fiercely affect the financial sector and the economy (Figure 9).

Figure 9. Unemployment in Spain by age groups



The second self-feeding loop: Debt deflation and aggregate demand

Non-performing loans appear to be the most immediate threat for the financial sector and for the economy. However, a much more menacing element of the current development of household debt lies in its potential to weaken aggregate demand to an extent that prevents a successful recovery.

This effect of household deleveraging would be in line with a rather heterodox, although recently revived, theory of debt deflation developed by Irving Fisher and Hyman Minsky.¹⁰ Under this hypothesis, a shift in the perception of what constitutes a sustainable level of debt (linked to excessive debt and decreasing confidence of economic actors) leads to forced or natural deleveraging, which creates a drop in asset prices and thereby generates deflationary pressures in the economy. The real value of debt is thus increased, making the debt burden less sustainable, triggering further deleveraging and creating a self-feeding loop of low aggregate demand, investment or both.

Unless this vicious cycle is broken, the prospects of swift recovery remain low for both households and non-financial businesses. This theory suggests that household deleveraging is not a sign of a recovery but an effective cause of its sluggishness.¹¹ Unless other sectors (state or businesses) are able to bear additional leverage in these periods, a quick recovery becomes a near-physical impossibility.

An alternative account of this phenomenon would revolve around uncertainty and consumer confidence. Low consumer confidence appears today to be one of the main motors of the rather swift deleveraging in Europe's periphery and could also be a precursor of a more generalised fear of a long-term economic depression, since the expectations of recovery did not materialise and uncertainty has been increasing steadily. This bad mood among consumers translates necessarily to levels of loans to non-financial corporations, which fear low demand and postpone or retract altogether their investments, therefore further diminishing the prospects of future growth. This sets the European continent into a low-demand vicious circle with similar or identical effects as the debt deflation theory.

Either way, such effects impose a serious strain on countries, which have not registered any significant asset bubble prior to the crisis and have thus theoretically avoided misallocation of capital. Indeed, there was nothing that could be identified as a genuine household-debt bubble in Portugal, with real indebtedness growing by as little as 25% from 2003 to its peak in 2010 (Figure 6). However, in terms of deleveraging, the country is firmly imbedded on the same path, although delayed, as more leveraged states, such as Spain. The Portuguese case shows us that deleveraging can be triggered in the absence of an asset bubble merely due to the recession, low consumer confidence and therefore low future income expectations. Also in many other countries, the current reduction of household debt appears to be a result of severely depressed economies rather than an adjustment to more sustainable debt levels from speculative heights.

Although deleveraging would be quicker under recovery, households may now be under pressure to increase their debt-reduction efforts beyond the elimination of the pre-crisis excess credit, mainly due to the omnipresent narrative of necessary deleveraging. This has the potential to trigger excessively deep debt-reduction in the short term, unnecessarily inflicting further harm to the economy.

¹⁰ I. Fisher (1933), "The Debt-Deflation Theory of Great Depressions", *The Econometric Society*, 1(4), pp. 337-357 and H. Minsky (1992), "The financial instability hypothesis", The Jerome Levy Economics Institute Working Paper No. 74.

¹¹ Eggertsson & Krugman, op. cit.

What can and cannot be done?

Two broad policy responses offer the possibility to lessen the pressure on southern European households and diminish the probability that household debt has further depressing effects on the economy in the midst of a second-dip recession. Unfortunately, the most successful solution is near to impossible to come into force under current political and economic constraints.

We have learned from the history of financial crises that the most successful cases of deleveraging come in two phases: first, households and companies reduce their debt, while the government itself takes on a bigger leverage to sustain the recovery and help the economy to achieve a near-full employment. Subsequently, when the economy starts to recover, the focus of deleveraging shifts towards the government, acting thus in a counter-cyclical way. This mechanism is able to avoid self-feeding effects on the aggregate demand, unnecessary deepening of a recession, and significant dead-weight losses. Unfortunately, Europe finds itself partly unable and partly unwilling to replicate such an ideal scenario. Long-term credible political commitments for deleveraging over a business cycle remain a hardly realisable plan also due to the institutional set-up of the European Union.

However, there is a more feasible solution within the current institutional constraints, which could help households and the economy in Europe's periphery to avoid unnecessary effects of ineffective household deleveraging. In order to avoid the further self-feeding phenomena related to households' NPLs, it is necessary to break the link between weak sovereigns and the financial sector. This move is as urgent as it is economically justified in the case of Spain. Spanish households have managed reasonably well to avoid high delinquency rates on their own liabilities, while they remain *de facto* liable in their capacity as taxpayers for bad liabilities of other sectors.

If Greek-type, self-feeding effects of household debt triggered by a second or a prolonged recession are to be avoided, especially in countries such as Spain, there must be safety nets for systemically important financial institutions far larger than the current national ones. However, if the project of the European banking union and most importantly its bank resolution component is to be applied after the second wave of household defaults with no retroactivity enshrined, the project will simply fall short of expectations to stop the dangerous self-feeding effects of non-performing household loans.

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