We need to deal with household debt now before the next financial crisis hits

What will happen to indebted households when the next recession hits Europe? Strongly pro-cyclical financial policy in the US is likely to trigger over-heating and recession in the US perhaps already at the end of next year. Many economists predict a recession to strike Europe a year later. One thing is sure. Sooner or later a recession will arrive and with already near zero level interest rates the means to fight it are more limited than they were after the economic collapse of 2008.

During recessions, households face problems in meeting their financial obligations. A debt, whether small or large, is not a sign of financial problems as such. Indeed, it may even indicate a high level of solvency. In fact, highly indebted households tend to have relatively high incomes and wealth. Loans serve an important societal function in promoting human capital investments and owner-occupied housing. Accumulated capital also helps individuals and households manage social risks such as unemployment or illness.

In the US the global economic crisis resulted in the loss of eight million jobs between 2007 and 2009, more than four million homes were lost to foreclosures. In the UK the number of mortgage repossessions almost doubled from 25 900 in 2007 to 47 700 in 2009.

The juggernaut of a looming recession is closely linked to increased wealth inequality. A poor man's debt is a rich man's asset. To balance supply and demand for credit, the creditor must find new borrowers. It comes with a destructive feedback loop where the rich invest more and more money in financial markets. As the rich save and the poor borrow, the debt will increase until the markets collapse.

As demonstrated in my recent book, most of the numerous attempts to define over-indebtedness fail to capture the very essential feature of the phenomenon, which distinguishes it from other measures of limited economic resources, such as poverty. That is the qualitative worsening of people's economic and social conditions. Poverty research is troubled with identifying how a non-poor person becomes a poor person. However, when it comes to debt the case is clear. To understand the total effects of over-indebtedness we need to define the over-indebted as those who have defaulted on claims which have been confirmed through court and which are collected by creditors.

When a debtor fails to meet a financial commitment and turns into a default-debtor, a large variety of legislated processes are set in motion. Depending on jurisdiction, they include wage garnishment, levies on bank accounts or motor vehicles, place a lien on property or force the sale of an asset, which can be the family's home. Over-indebtedness will also lead to expensive and tedious bill paying and make it difficult to get a job (possible employers may check credit records and shun employing over-indebted workers), furnish a home, or get a plan for old age through life insurance and pension savings.

Apart from the negative consequences to economic growth, the financial industry and housing markets, over-indebtedness comes with individual predicaments (Table). Research shows that over-indebtedness is associated with all the miseries of limited financial resources. In addition, over-indebtedness comes with a social stigma that aggravates the negative consequences of debt-induced poverty. As a stigma-related societal outcome over-indebtedness may further erode general trust in public institutions, which may increase support for populist leaders and policies.

Table. Individual and societal consequences of over-indebtedness by lack of material resources and stigma of debt and possible policies to alleviate them

	Individual	Societal
Effect of low incomes and assets	Social participation Financial exclusion Welfare dependence Education	Economic growth Financial industry Housing markets
Effect of debt-related stigma	Mental and physical health Employment Human relations Intergenerational effects	General trust Innovation potential Public expenditures
Policies to alleviate over-indebtedness	Financial literacy	Regulating financial markets Swift debt discharge

Quantitative easing saved the world economy from a complete disaster after the financial collapse in 2008. However, it has led to high levels of household debt in a number of countries including the UK. There is a lively debate on conventional and unconventional macro-economic policies to navigate in the new economy of almost non-existent inflation and close to zero interest rates, but very little discussion about household debts. If and when growth stalls those households with unsustainable debt levels will not be able to keep their financial commitments.

To save society from the devastating consequences of economic recession, there is an urgent need to develop social policy solutions to over-indebtedness before the next crisis hits the global market. Critical financial literacy education focusing on pitfalls and injustices in the credit markets may allow individuals to better understand the system and avoid problems. No doubt swift debt discharge is the most effective solution to debt problems. An important argument for swift debt discharge is also the fact that creditors are much better insulated against the risk of default than debtors. The rich own the stocks and bonds of the banks. Thereby they also own the loans the bank has made, and the interest payments flow through the financial system to the rich. Financial regulation, including tax allowances for loans as well as public loan programmes and repayment subsidies should be analysed critically since they may increase uncontrollable and unsustainable indebtedness.

The time to repair the roof is when the sun is still shining. This is not an easy task. The traditional bank lending view has been the dominant paradigm to fight against consequences of economic crises. Easing the conditions for consumer bankruptcy is likely to provoke opposition from financial institutions and judicial actors. Causes of over-indebtedness are deeply embedded in the social and economic forces of the global capitalist system. Over-indebtedness should be recognised as a social risk which calls for collective solutions across different levels and programmes of collective action. Credit-based social policy calls for measures to solve over-indebtedness holistically and strategically. That entails coordination between different ministries and government agencies dealing with a wide range of topics, from regulation of financial markets to consumer education.

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Notes:

- *This blog post is based on the author's book Household Debt and Economic Crises – Causes, Consequences and Remedies, Edward Elgar, 2018.*
- *The post gives the views of its author(s), not the position of the institutions they represent, the LSE Business Review or the London School of Economics.*
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