

# Where is the European household sector in the deleveraging cycle?

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*One of many uncertainties still hanging over Europe's economic recovery in the hostile post-crisis economic environment is how the household sector will cope with the debt reduction being sought. As a decade-long trend of generous credit expansion goes into reverse, deleveraging in the household sector moves forward, but the trend is far from homogeneous across nations. It is expected that household deleveraging will take time and that it will require continued policy support to prevent an abrupt retrenchment from debt, which could obstruct countries' recovery.*

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In retrospect, we have seen how excessive credit growth can be a powerful predictor of financial crises, even though in most major economic downturns it has been ignored or reacted to too late. Misaligned credit volume increases created either by over-extended monetary policy or by a loose augmentation of credit by the credit multiplier – usually through sophisticated financial innovations – can easily create asset bubbles. Only when the boom turns to bust, which usually starts with a sudden market correction in one or more asset classes, the comprehension of the situation becomes real and the rectification of the highly leveraged economy begins – a process that is far from instantaneous. Europe's debt crisis is just one of many examples of how toxic the consequences can be when countries have too much debt and far too little growth.

Although financial innovation has increased access to credit, it has also made the credit cycle more volatile. Many observers have traced the emergence of the eurozone debt crisis back to historically low interest rates, declining savings rates and credit bubbles caused by a rapid accumulation of both public and private debt. Latest ECB data show that retail credit growth in the euro area has reversed drastically from pre-crisis levels

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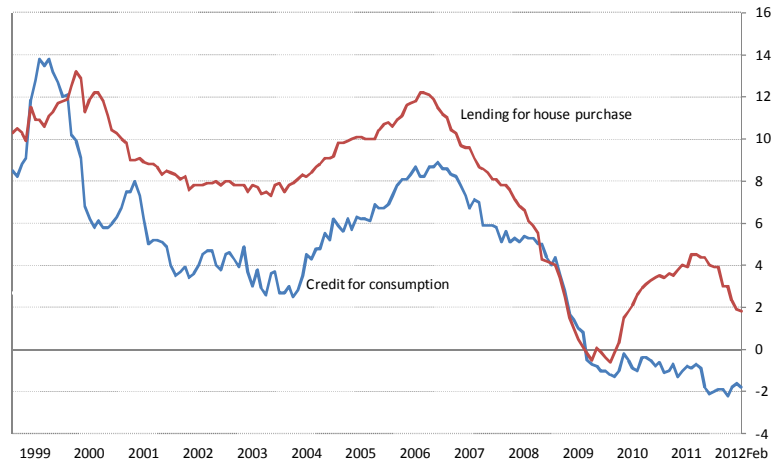
<sup>1</sup> ECRI Commentaries provide short analyses of ongoing developments with regard to credit markets in Europe. ECRI researchers as well as external experts contribute to the series. External experts are invited to suggest topics of interest for ECRI Commentaries.

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(Figure 1). At peak level, the annual growth rate of credit for mortgages and consumption stood at 12% and 8%, respectively. Mortgage and consumer credit has been considered as the main drivers of household sector indebtedness.

**FIGURE 1. ANNUAL CREDIT GROWTH RATES (%)**

Households in the euro area



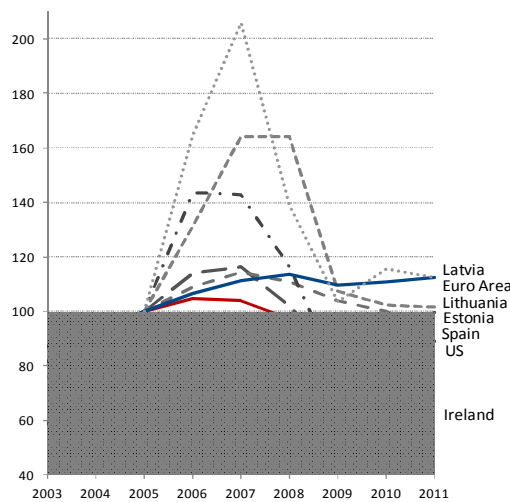
Note: Neither seasonally nor working day adjusted.

Source: European Central Bank.

Rising asset prices in the pre-crisis period allowed borrowers to add debt without increasing leverage. However, declines in asset values, such as property prices, has propagated the risk associated with elevated household leverage in the aftermath of the crisis (Figure 2). The borrowing capacity of many households has become significantly constrained by the value declines in collaterals.

**FIGURE 2. HOUSE PRICE INDEX**

Base year 2005 = 100

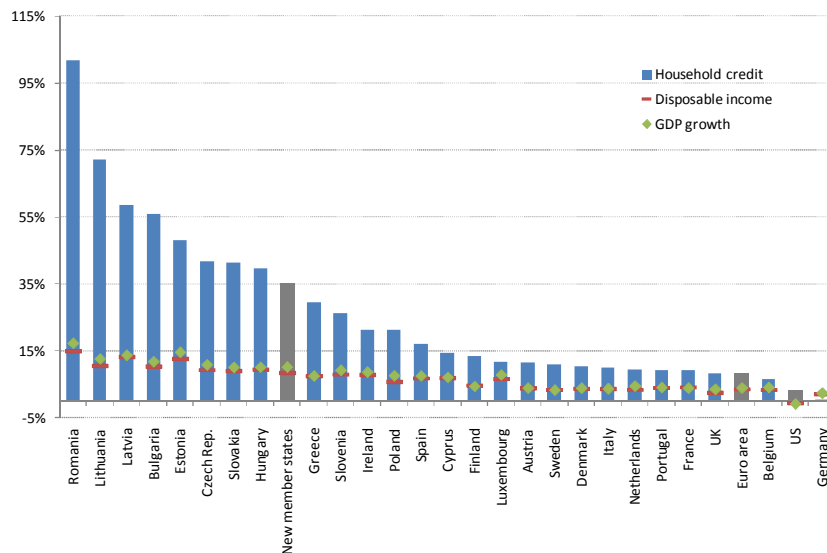


Source: BIS, ECRI Analysis.

There are, however, differences between EU member states to be mentioned when it comes to the build-up of debt. In the run-up to the crisis, the fast-paced growing economies from the Eastern European bloc had double-digit credit growth figures, which allowed them to catch up with Western European countries. Although mature economies from Western Europe had less momentum in growth rates, the retail credit sector still grew a lot faster than the real economy in the run-up to the crisis. The way credit growth has outpaced income and GDP growth has been staggering (Figure 3). In recent years, the effect from the crisis and the abrupt reversal of the credit cycle has made households more prone to improve their balance sheet.

### FIGURE 3. CREDIT TO HOUSEHOLDS, DISPOSABLE INCOME AND GDP GROWTH

Compound average growth rate (CAGR) 2000-07 – Nominal terms



Note: Credit to households correspond to the aggregate amount (stock) of consumer credit, housing loans and other loans at the end of the year granted by the resident MFI sector to resident households and NPISHs for housing and consumption purposes.

Source: European Credit Research Institute (ECRI), 2011 Statistical Package "Lending to households in Europe", Brussels 2011.

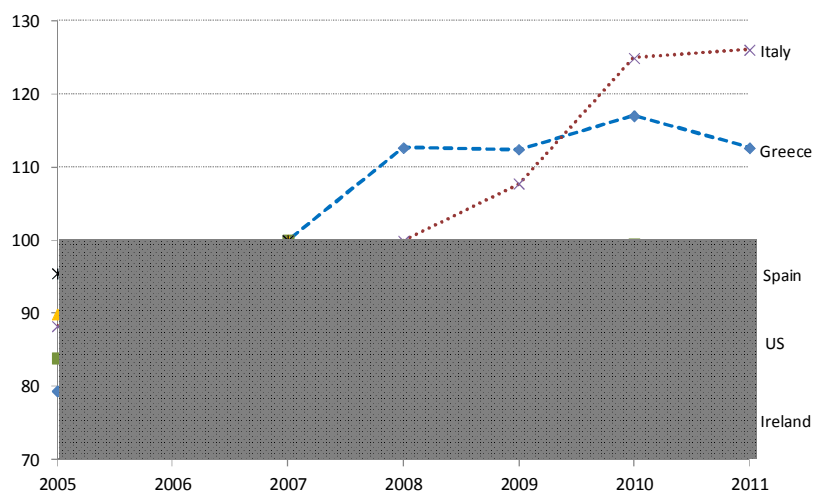
The debt-to-income ratio of households in Ireland has come down from 161% in 2007 to 122% in 2011. Marginal declines are present in Spain and Greece, while Italy continues to sustain its debt-to-income ratio at around 60% (Figure 4). US households have so far responded to the crisis in a more significant manner. The first default-wave of underwater mortgages surely helped to reduce the aggregate debt level of US households, but also ambitious policy measures such as refinancing options and write-downs have played a key role in bringing down the debt level in a more ordinary fashion.

**FIGURE 4. DEBT-TO-INCOME RATIO**

Credit to households relative to disposable income (%)

	2005	2006	2007	2008	2009	2010	2011
<b>Greece</b>	49%	57%	61%	69%	69%	72%	69%
<b>Spain</b>	105%	119%	125%	123%	121%	125%	119%
<b>Ireland</b>	145%	158%	161%	144%	150%	146%	122%
<b>Italy</b>	42%	45%	48%	48%	52%	60%	61%
<b>US</b>	121%	125%	127%	120%	120%	114%	109%

Index 2007=100



Source: European Credit Research Institute (ECRI), 2011 Statistical Package "Lending to households in Europe", Brussels 2011.

In Europe, one can observe that the process of household deleveraging has started, albeit hesitantly, in EU member states worst hit by the crisis. Deleveraging is occurring either by an increasing amount of defaulting loans or by debt retirement. Also banks' reluctance to extend credit under these stressed market conditions is contributing to the process. The IMF's Global Financial Stability Report<sup>2</sup> forecasts a mild recession for the euro area in 2012 as growth continues to be anaemic. If the economic recovery is prolonged, it is only likely that deleveraging will accelerate in the years to come.

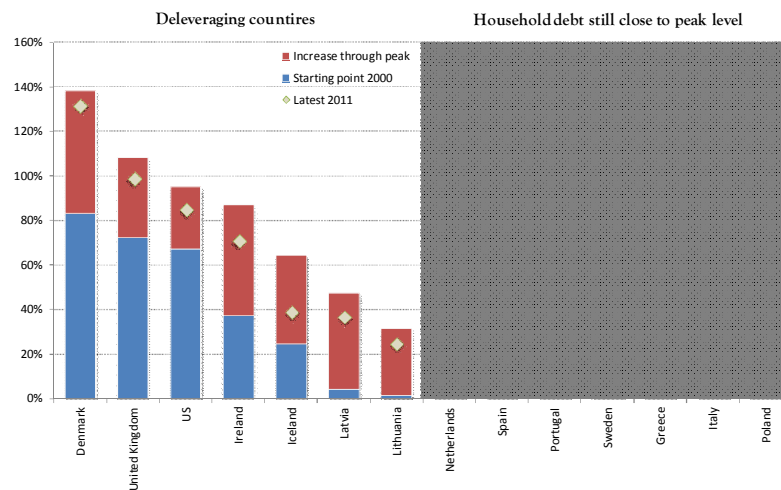
Household debt relative to GDP demonstrates a heterogeneous trend in household deleveraging (Figure 5). For example, countries such as Ireland, Iceland, Latvia and Lithuania, whose households accumulated a great part of their outstanding debt during the boom period, have witnessed a pronounced debt retrenchment where deleveraging is being clearly manifested. On the other hand, deleveraging by households in southern

<sup>2</sup> Global Financial Stability Report, IMF, April 2012  
<http://www.imf.org/External/Pubs/FT/GFSR/2012/01/index.htm>.

European countries, such as Spain, Italy, Portugal and Greece, continues to be sluggish. However, on a standalone basis, it is hard to find consensus regarding how much debt is considered to be sustainable for a single country. Sweden and the Netherlands are a prime example of two countries where deleveraging is still non-existent, despite high levels of household debt. Nonetheless, concern over household over-indebtedness is still relevant. In fact, policy-makers in Sweden imposed an 85% loan-to-value cap on mortgages in October 2010, as a response to its buoyant property market, which has been one of the few where house prices did not adjust downwards during the crisis.

**FIGURE 5. HOUSEHOLD DELEVERAGING**

Household debt relative to GDP (%)



Source: European Credit Research Institute (ECRI), 2011 Statistical Package "Lending to households in Europe", Brussels 2011.

Historical experience suggests that deleveraging is indeed a slow process and more is likely to come before balance sheets are fully repaired across the household sector in Europe. If debt levels of the household sector would need to come down, opting for an orderly debt reduction that minimises adverse effects to the economy is preferable. Here the Swedish approach for resolving its banking crisis of 1991-93, where household over-indebtedness was central, has been portrayed as a successes story in crisis management, but the exportability of the model is nevertheless questionable.<sup>3</sup>

The dilemma facing many countries today is that they are in need of economic growth but at the same time they are being weighed down by high debt burdens across numerous sectors. When great parts of the economy are forced into a savage multi-sector deleveraging process, which is the case for southern European countries, no one

<sup>3</sup> Lars Jonung (2009, The Swedish model for resolving the banking crisis of 1991-93. Seven reasons why it was successful. DG ECFIN, European Commission, Brussels ([http://ec.europa.eu/economy\\_finance/publications/publication14098\\_en.pdf](http://ec.europa.eu/economy_finance/publications/publication14098_en.pdf)).

is left that can temporarily assume more debt to sustain the economy, as was done in Sweden, where aggressive monetary policy and large government spending supported the economy from a hard landing. It remains clear, however, that the global magnitude of the present financial crisis dictates different rules within a more complex macroeconomic and financial setting compared to the situation when Sweden designed its bank resolution policies. EU policy-makers are therefore facing greater challenges today in restructuring and supporting a global and interlinked financial system. However, much is still to be accomplished politically before a smooth deleveraging process can be ensured across the sectors of the economy. In Europe it is expected that household deleveraging will be a multi-year process that is part of the wider public and financial sector deleveraging, and it will require continued liquidity and policy support to prevent an excessively rough debt retrenchment that could obstruct the recovery path.

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