Box 6

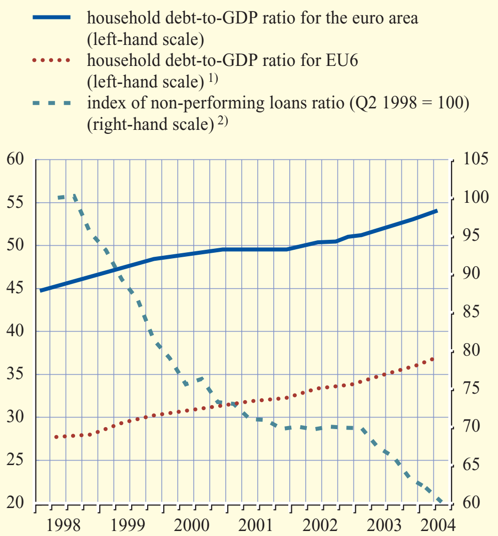
TRENDS IN HOUSEHOLD DEBT AND NON-PERFORMING LOANS IN THE EURO AREA

Since the late 1990s there has been a rapid accumulation of debt by households in the euro area. In the fourth quarter of 2004 the ratio of total household debt to GDP was somewhat above 55%, around 10 percentage points higher than in early 1998. The higher debt ratio would most likely amplify the impact of income or interest rate shocks on household balance sheets and debt servicing. As most of the rise in indebtedness reflects strong mortgage financing growth in an environment of dynamic housing markets, such amplifying effects can also emerge as a result of pronounced changes in house prices and thus in the value of collateral. In the context of shocks, the higher level of debt thus implies a greater risk that households will face problems in servicing their debt and that the number of non-performing loans will increase. This box discusses some factors that can help to assess linkages between developments in debt and non-performing loans.

Non-performing loans are defined as loans that are at least three months in arrears. However, this concept can differ across countries in terms of the regulations and policies on how quickly non-performing loans are written off or otherwise dealt with and thus drop out of the statistics. The public availability of data on non-performing loans in euro area countries is rather poor

Chart A Debt and non-performing loans of households in the euro area

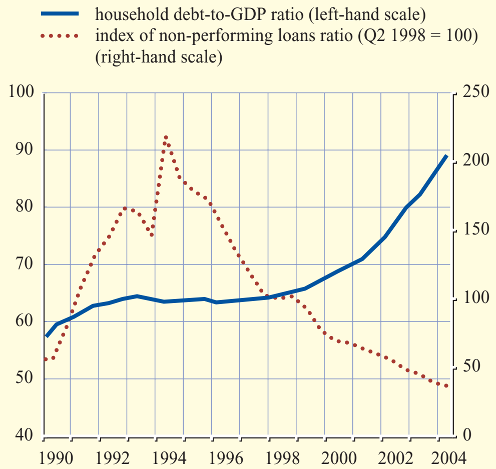
(percentages; index Q2 1998 = 100)



Sources: ECB, Eurostat.
1) The ratio includes the six countries for which non-performing loans data are available (Belgium, Spain, France, Ireland, Italy and Portugal). By contrast with the euro area-wide figure, this ratio is calculated on the basis of MFI loans only.
2) The ratio is calculated as countries' non-performing loans as a share of countries' total loans. The weighted index is calculated using the share of each country in the aggregate debt.

Chart B Debt and non-performing loans of households in the United Kingdom

(percentages; index Q2 1998 = 100)



Sources: Council of Mortgage Lenders, APACS and Bank of England.

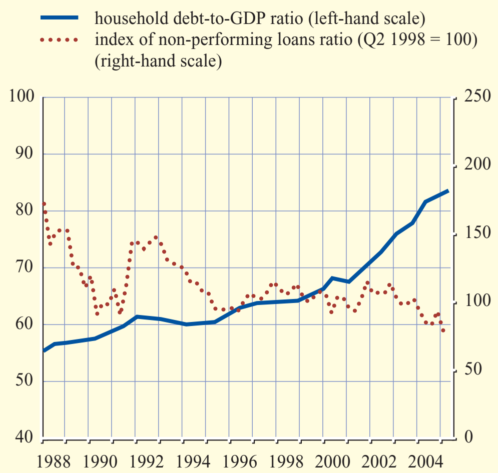
and, to the extent that they are available at all, the sectoral breakdown into households and non-financial corporations typically covers only a short period. Moreover, the lack of harmonisation of the data suggests that they need to be assessed with caution. Chart A shows an index of the ratio between household non-performing loans and total household loans, constructed on the basis of data published by the national central banks of Belgium, Spain, France, Ireland, Italy and Portugal. These countries account for 57% of the euro area's GDP, but only for 40% in terms of the stock of household loans. The sample covers the period from the second quarter of 1998 to the second quarter of 2004. The data show that the ratio of non-performing loans has been falling since 1998, especially in the first part of the period, which was characterised by strong economic growth, but also during the subsequent economic slowdown.

Broadly similar developments in the debt ratio and the ratio of non-performing loans have been observed in the United Kingdom and the United States. In both these economies, the debt ratio has accelerated since the late 1990s. As regards non-performing loans, the ratio has strongly declined in the United Kingdom over the past few years, continuing the downward trend that started after the housing crisis of the early 1990s. By comparison, the decline in the ratio of non-performing loans in the United States has been more muted since the late 1990s (see Charts B and C).

When assessing the continued decline in the ratio of non-performing loans, it should be noted that this indicator naturally lags unsustainable debt developments. The assessment of the risks associated with the accumulation of debt over recent years thus needs to focus directly on the

Chart C Debt and non-performing loans of households in the United States

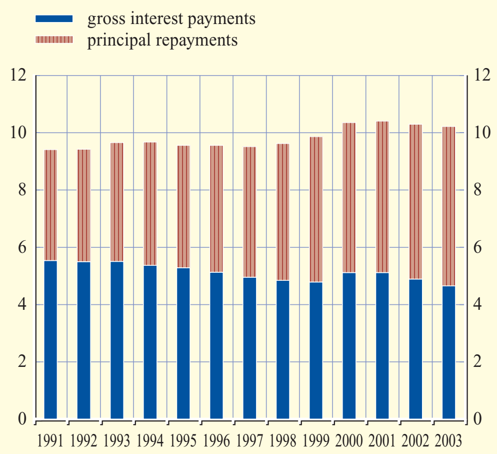
(percentages; index Q2 1998 = 100)



Source: US Federal Reserve Board.

Chart D Interest payments and principal repayment of households in the euro area

(as a percentage of disposable income)



Sources: ECB and ECB estimates.

question of whether this accumulation is sustainable. In this respect, it can be argued that the strong rise in the debt ratio in past years reflects an equilibrating process.

First, as part of the convergence process prior to Monetary Union, inflation rates across the euro area converged to low and stable levels. More stable macroeconomic conditions since the end of the 1990s are reflected in lower unemployment rates and lower real interest rates, implying less uncertainty with regard to income streams and lower debt servicing burdens. This allows households to incur more debt at a given level of income without necessarily incurring more risk. For instance, in the euro area the ratio of the debt burden (i.e. interest payments and principal repayments) to household disposable income has remained broadly stable since 1998 at around 9-10%, despite the rise in the debt ratio (see Chart D).

Second, the rise in mortgage debt might be associated with a structurally higher demand for housing in the face of demographic change. This could be explained by the fact that the baby boom cohorts of the 1960s have in past years reached the age at which households are most likely to buy a house. In addition, there is a secular trend towards smaller households.

Third, there may also be structural factors that can more directly explain the lower ratio of non-performing loans. These would, for instance, include the use of better risk management techniques by banks and/or the availability of better opportunities for larger banks to offload part of their credit risks, either via securitisation or by using credit derivatives.

Notwithstanding such explanations for structurally higher debt and lower non-performing loans, the risks associated with the likely linkages between strong house price increases, on the one hand, and a high household debt ratio and low ratio of non-performing loans, on the other, need to be closely monitored. The Eurosystem's bank lending survey suggests, for instance, that the continued net easing of credit standards for loans to households for house purchase in past quarters reflects strong competition among banks rather than an improvement in housing market prospects. The possibility cannot be ruled out that the general risks associated with the rapid rise in house prices are currently being underestimated due to the strong competition in the banking sector and the current low levels of non-performing loans.